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Public Hearing on Creative Financing

Assembly Committee on Finance and Insurance

CALIFORNIA LEGISLATURE

ASSEMBLY COMMITTEE
ON
FINANCE, INSURANCE AND COMMERCE

FINANCIAL INSTITUTIONS SUBCOMMITTEE

Public Hearing
on

CREATIVE FINANCING

Transcript of Hearing
San Francisco, California
August 5, 1981

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Tom Bane
Ross Johnson
Bill Lancaster
Alister McAlister

Leo T. McCarthy
Patrick J. Nolan
Louis J. Papan
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CHAIRMAN DOUGLAS H. BOSCO: I would like to welcome everyone and introduce the members who are here. To my far right is Alister McAlister, who is Chairman of the full Finance Insurance and Commerce Committee, and to my far left is Assemblyman Larry Stirling. This is his first term and he is a very fine member of our Committee, and Jim Costa, who is not a member of the Committee, but who is the author of a bill that is one of the reasons we are holding this hearing. The field of creative financing is one that is occupying a great deal of our thought on this particular subcommittee these days, because of the fact that we have been deeply immersed in the question of assumable loans, whether we should in California end the assumability of loans or allow them to continue under the Wellenkamp decisions. Obviously, that type of decision would have far reaching consequences for a number of people.

The creative financing that has taken place in the last few years is one of interest to us in light of this issue of loan assumability. Today, our agenda begins with the representative of the Department of Consumer Affairs who will lay some of the foundation for the hearing by describing the legal and economic climate in which the creative financing is flourishing. The Commissioner of Real Estate is present to discuss the activities of that Department's licensees from the point of view of the regulator. We plan to hear from two attorneys, who limit their practice to real property financing, on the practical aspect of putting together financing to accomplish a home sale and the legal implications of the participating parties. Only one of these gentlemen, however, is able to attend...today because of the Air Traffic Controllers strike.

We have a Deputy District Attorney from San Diego, who will describe for the Committee some of the schemes he has encountered in his work with the fraud division of the District Attorney's office and we have representatives of the Real Estate and lending industries to give us their perspectives in the way of definitions, issues, and problems associated with creating financing for borrowers and lenders, and we have two economists who will describe the economic fall-out, if you will, of creating financing and its implications for the future contours of the mortgage market.

We would like to begin this morning by hearing from Dick Elbrecht, who is the supervising attorney for the Division of Consumer Services of the Department of Consumer Affairs. Welcome, Mr. Elbrecht.

MR. DICK ELBRECHT: Thank you, Mr. Chairman. Mr. Chairman and members of the Committee. I am appearing here today at the request of our Director, Mr. Richard B. Spohn, who is presently on his annual two-week vacation with his wife and children.

The purpose of this hearing is to explore creative financing. Creative financing is a method of home finance on which buyers and sellers have begun to rely more heavily as reasonably priced long-term credit has become unavailable.

In the following testimony, I will share some thoughts on creative financing. I will look at it from the viewpoint of the consumers, both buyers and sellers. I will also attempt to describe the larger context in which creative financing is taking place. I will also express some concern about whether creative financing, in which the buyer agrees to make a large balloon payment, is generally suitable for use in today's market, where the exact source of the funds needed to make the balloon payment is not known.

As I use the term creative financing, the term does not include financing by long-term fixed or adjustable rate mortgages, or graduated payment mortgages, shared appreciation mortgages, or other traditional or innovative home mortgage instruments which provide long term home finance. Nor does it include equity loans made to persons who already own their own homes, borrowing on them to pay for living expenses, or luxuries, or to consolidate debts and the like.

While some of the same thoughts will apply to each of these financing mechanisms, creative financing of the purchase of homes deserves the separate treatment it is being given at these hearings. Creative financing of residential real estate has always been with us. At no time has long-term lending by financial institutions been the sole source of home finance. It has always been supplemented by some forms of creative financing. Indeed, prior to the great depression, there was no such thing as long-term, fully amortized, home financing. Then, mortgage loans usually ran for only five years, and a much smaller percentage of the purchase price was financed. Moreover, unless the payments were quite large, the buyer was faced with a balloon payment at the end of the five-year term. If buyers couldn't make that payment, buyers had to refinance the loan or default. During the great depression, many home buyers defaulted when lenders refused to refinance their mortgages. It was only with the passage of the federal Housing Act of 1934, that the long-term, fully amortized, non-balloon payment home mortgage came into widespread use.

ASSEMBLYMAN ALISTER MCALISTER: ...Mr. Elbrecht. Didn't we have in fact during the depression moratorium legislation on foreclosures even in some states?

MR. ELBRECHT: That's correct, and I believe that is also when our anti-deficiency legislation was adopted here in California.

Since then, long-term, fully amortized home finance has become the norm with the total home mortgage debt, financed mainly by long-term, fully amortized mortgages, increasing dramatically from $17 billion in 1940, to approximately $300 billion in 1970, to some $973 billion in 1980. It is the contrast between the norm of the 1940's through the 1970's and today's practices that has given rise to the use of the term creative financing, and it is the similarity between much of today's creative balloon-payment financing schemes and the conditions that preceded the great depression that has given many observers cause for concern.

The Federal Home Loan Bank of San Francisco reports that delinquencies of sixty days or longer have increased to about .82 percent of the mortgages held by California's savings and loans, up from .46 percent one year ago. The number of recorded notices of default also has increased. For instance, in Santa Clara County, for the fiscal year ending in June of 1981, approximately 6,100 notices of default were recorded, up from 3,800 in 1979 and 3,900 in 1980.

In Los Angeles County, 19,385 default notices were recorded during the first six months of 1981, compared with 11,167 and 13,194 in 1979 and 1980 respectively.

These statistics show a radical increase in the default rate and also in the rate of filing of notices of default in connection with foreclosure proceedings.

ASSEMBLYMAN MCALISTER: Could you give the numbers again.

MR. ELBRECHT: The numbers are on page three of the statement in the middle of the page. Exact numbers are there and I could repeat them for you if you would like.

ASSEMBLYMAN LARRY STIRLING: Is that above or below the national average?

MR. ELBRECHT: I don't have that statistic. I think the message of these statistics is that there is a change, and, as I will indicate here today, this gives rise to concern about the capacity of home mortgage borrowers to sustain the increases in the payments that will result upon refinancing of balloon payments in an economic environment in which interest rates are higher than they presently are, which is a distinct possibility.

ASSEMBLYMAN STIRLING: I understand, I am just trying to figure out why the California default is half the national average.

MR. ELBRECHT: Well, we have a strong economy, probably one of the strongest in the country, and that is something that we can really be proud of. We must be aware, take a look at the trends, and perhaps at least keep our own local trends in mind in developing policy. That is the reason we have presented these statistics.

ASSEMBLYMAN JIM COSTA: Mr. Elbrecht. What is the common procedure after a notice of default.

MR. ELBRECHT: After the recording of the notice of default, the buyer has a period of 90 days in which to reinstate the mortgage by paying the delinquent payments, plus certain limited expenses; and after that 90-day period, the foreclosing creditor can complete the foreclosure proceeding. Until the actual time of sale, the consumer still has the right to redeem by paying the full unpaid balance of the mortgage, plus all of the foreclosure costs and related charges, which could become quite substantial; but that requires that the consumer actually obtain a new loan. The filing of the notice of default is the commencement of a three-month period in which the borrower can preserve the existing loan simply by paying the delinquent payments plus certain limited expenses.

The rate of filing of notices of default doesn't necessarily reflect the rate of ultimate foreclosure sales, because a lot of people are, in fact, able to cure by bringing the payments current; and even when they don't, a lot of them are able to sell the property during the interim period and realize their equity and become renters instead of owners. And some perhaps move to a less expensive home.

The critical issue today is just who is going to refinance, and at what cost, all of the short-term balloon-payment first, second and third mortgage loans that have been made and that are now beginning to become due and that will come due in steadily increasing volume during the next few months and years. Will the widespread unavailability of refinancing during the great depression repeat itself in the 1980's? Will the cost be more than most people can afford? An equally pertinent question is: Can any buyer today, or tomorrow, reasonably commit himself or herself to make a short-term balloon payment some three, four or five years hence? Can a lender or seller who provides short-term balloon payment housing credit reasonably expect to be repaid when the balloon comes due? Can a realtor properly accept a commission on a sale in which the parties do not genuinely understand the risks of a balloon payment which perhaps **cannot** be refinanced?

Today, very little thought is being given to the possibility that when these notes come due, the anticipated opportunities to refinance at an affordable rate may not materialize. Clearly, not all short-term balloon payment creative financing of home purchase transactions should be questioned. Creative financing has been with us for as long as real property has been sold and purchased. We have outlined in our statement a whole variety of kinds of creative financing techniques that have been used in past years. So creative financing is nothing new. It is the term that is new.

It is difficult to find fault with creative financing of the purchase of a home in which the buyer is assured of receiving funds needed to make the balloon payment when it is due. For example, if the buyer reasonably anticipates receiving proceeds from the sale of other property or a bonus, commission or tax refund, or an inheritance, or other gift, the use of creative financing techniques in which the buyers obligations are linked to the receipt of additional funds may be most appropriate. If the buyer intends to sell the house itself before the balloon payment is due, then again, a balloon-payment mortgage may be appropriate with a reasonable assurance that the necessary funds will be in hand at the time they are needed. It is probably not unreasonable, in most cases, for a purchaser to make commitments based on those expectations. In recent years, however, individuals have increasingly committed themselves to make purchase-money balloon payments in the expectation that the source of the funds needed to make the balloon payment would be the property itself.

Two premises have become ingrained in our thinking. First, that the property, every property, will appreciate substantially. Second, that because of the enhanced value of the property, it will be possible to procure a refinancing loan encompassing both the first-lien mortgage and the balloon or balloons, when they become due.

ASSEMBLYMAN LOUIS PAPAN: Let me ask you a question. Where was the Department on the Wellenkamp decision?

MR. ELBRECHT: We have some statements to make on that issue today, sir. I'm leading into the question of the relevance of the Wellenkamp decision.

CHAIRMAN BOSCO: I'll watch carefully and be sure he does not...

MR. ELBRECHT: We go into it in quite a bit of detail beginning on page eight or nine. As we have indicated there, because of the Wellenkamp decision, the Federal National Mortgage Association has required that all mortgages that it purchases from lenders in California must include the lender's option to call the loan after seven years. And the fact is that the Wellenkamp decision has meant that insofar as mortgages are destined for resale on the secondary market, they are all balloon-payment mortgages. They are all due in seven years.

ASSEMBLYMAN PAPAN: You were into it in some detail when we were introducing a bill to reverse it.

MR. ELBRECHT: I think this is our first statement on the subject, sir.

MR. PAPAN: Last year did you oppose the bill being carried, and I don't know who the author was, that tried to undo Wellenkamp.

MR. ELBRECHT: Honestly, I am not aware of...

MR. PAPAN: You are laying a lot of groundwork there and using state funds to reach a lot of people prematurely.

MR. ELBRECHT: I don't think we were on that issue last year, I'm not aware that we were, sir.

MR. PAPAN: I think you were...the Department of Consumer Affairs was.

MR. ELBRECHT: We are making some statements here today.

Two recent changes in the market have given rise to a great deal of concern. One is the prediction by housing economists that the rate of appreciation in the nominal value of residential real estate is likely to slow or stop altogether, a prediction that seems to be coming true in many areas of the state with the softening in today's real estate market.

The other change is inflation's effect on our financial institutions, the organizations that act as financial intermediaries between persons who have money to save and those who wish to borrow, who have found it difficult to impossible to make long-term home loans in today's economic environment. In the accompanying paper entitled, "Housing Costs: Past, Present and Future," we have summarized the findings and conclusions of several housing economists who have analyzed the real estate market, and who foresee, indeed, assure us that there will be, a significant moderation, if not a cessation, in the increase in real estate values. One of these economists, Professor Douglas P. Diamond, states that as people's expectations of continuing increases in real estate values diminish, a large component of the current market value of real property, reflecting expectations of further increases in real estate values, will no longer be present. That is why some investors have been willing to tolerate a negative cash flow on their real property investments. While the process is working, it works quite well. When the balloon payment comes due, the value of the property has risen to the point where it will support the larger refinancing loan.

The process depends upon continuing real estate appreciation. And with the anticipated softening in the market, of which there is always some evidence, the appreciation which is a prerequisite for such refinancings may not materialize.

The second premise, that because of the enhanced value of the property, it will be possible to procure a refinancing loan encompassing both the first-lien mortgage and the balloon when it comes due, is also beginning to become unrealistic. The accompanying paper, "Interaction of Deposit, Interest Rate, Deregulation and Mortgage Instrument Design," explains some of the reasons for, and the consequences of, the drain of savings deposits from our financial institutions, mainly savings and loan associations, the effect of which has been to cut off what has been the major source of funds for use in making and refinancing home loans. Today, it is difficult to determine how successful the saving and loan industry will be in attracting the funds needed to continue making and refinancing home loans as they have in the past.

One thing is certain, the cost of such refinancing credit, if it is available at all, will be considerably more than anyone could have predicted several years ago. With financial deregulation proceeding a pace, the home mortgage borrower is in competition with all other borrowers for funds, including the United States government and the entire commercial and industrial sectors. It is not clear that the individual consumer seeking a refinancing loan will win out over large corporations garnering funds to purchase other institutions or the U.S. Treasury in its continuing efforts to refinance the federal debts.

ASSEMBLYMAN COSTA: Just a minute. There are changes today that relate to the federal policy towards investment capital that has normally centered in the area of housing, and that change has focused itself in the form of money markets and T-bills which we see as an increase towards the industrial sector for investment capital.

MR. ELBRECHT: Well, the Reagan administration, I believe, has indicated that its policies are going to move in the direction of facilitating and encouraging the movement of capital funds into reindustrialization as distinguished from movement into the housing sector. The money market mutual funds are a market response to inflation and the limits that savings and loan associations have on the amounts they can pay depositors. With federal regulation Q savings and loans and banks have been limited in what they can pay depositors. As a result of that limit, they haven't paid depositors enough to keep the depositors within their fold, so a market response to this phenomenon has been the emergence of the money market mutual funds which are unregulated. I can't say that that has been the result of anybody's policy...

ASSEMBLYMAN PAPAN: You are saying Regan?

MR. ELBRECHT: President Reagan.

ASSEMBLYMAN PAPAN: President Reagan as opposed to Regan who heads the Treasury Department?

MR. ELBRECHT: It's my understanding that a main thrust of the Reagan administration's economic policy is to foster and promote reindustrialization, and, if necessary, at the expense of housing.

ASSEMBLYMAN PAPAN: Can you tell me where Mr. Regan, the Secretary of the Treasury, came from that President Reagan appointed?

MR. ELBRECHT: I don't know, sir.

ASSEMBLYMAN COSTA: Merrill Lynch.

ASSEMBLYMAN PAPAN: So he is going to feather his bed in some way, since he came out of an industry that presently is taking funds from all over the country and from communities...

MR. ELBRECHT: It is a very controversial question as to whether money market mutual funds should not be regulated in the same way that banks and savings and loans...

ASSEMBLYMAN PAPAN: My question to you is could you possibly draw an inference as to someone who is involved in consumer affairs to say that here is a man who came out of a brokerage house that is presently contributing to the problem. Let's be political about it.

MR. ELBRECHT: I think I can be political about it in the sense that I know that one of the basic, fundamental, economic premises of the Reagan administration is that the free market should be allowed to do what it will, and that...

ASSEMBLYMAN PAPAN: I am asking you a question. The present head of the Treasury is a man named Mr. Regan. Did he not come out of a brokerage house? I am not encouraging President Reagan and his administration to continue the money...

MR. ELBRECHT: I supposed you could make an inference that his past connection with that industry...

ASSEMBLYMAN PAPAN: Let's make the inference, then.

ASSEMBLYMAN COSTA: I think that more important than that in the meetings that I have had, back in Washington in the last four or five months, there is, I think, a clear change in the intersection in the middle of the road. For the first time in thirty years, since World War II, housing no longer enjoys the priority that it had during Republican and Democratic administrations alike. And that investment capital is not there. It takes the form in the comments that you are making. It takes the form in other fashions which means that we are going to be more and more dependent on the state levels to try to create our own sources of investment capital for housing.

MR. ELBRECHT: That's correct. I think to be...

ASSEMBLYMAN COSTA: Right or wrong, it may be good or bad, I'm not arguing policy, but nonetheless, it means that money for housing in the private sector is not going to be there.

MR. ELBRECHT: To be politically even-handed, we should note that in President Carter's annual report to Congress of this last year, there was also a suggestion that there should be a reallocation of the nation's credit resources in the direction of reindustrialization, not specifically from housing, but from consumption, generally, so I would say there is some political bipartisan movement in that direction. It is not exclusively the Reagan administration's policy.

ASSEMBLYMAN STIRLING: When was the legislation that provided for the Regulation Q reform adopted?

MR. ELBRECHT: In 1980.

ASSEMBLYMAN PAPAN: It was introduced previously?

MR. ELBRECHT: That's correct. And that, in turn, was partly the result of inflation, which is the key to a lot of these problems. In short, the potential supply of low-cost funds for home financing is gone, and there is no reason to believe that these funds will be restored in time or volume or at a cost that will enable the increasing volume of creatively financed home purchases to be refinanced on terms like those that have prevailed in the past, even if real property should continue to appreciate at rates that were characteristic of the past.

ASSEMBLYMAN COSTA: I think that is very important to know. That is the opinion of the Department. That the refinancing is not going to be there for those who have got themselves in...

MR. ELBRECHT: It's a question we are raising. It's impossible to predict. We have many sources of potential credit. The savings and loan industry is regearing. We can see in today's papers that they are paying larger amounts for certificates of deposit, together with additional funds to savers which in turn will be lendable to home mortgage borrowers and others. We also have private investors and second mortgage loan brokers who will continue to be operative in the field.

ASSEMBLYMAN COSTA: The Department is not making a statement as to whether or not you believe that refinancing will or will not be there. You question...

MR. ELBRECHT: We are raising a question of concern that both sellers and buyers and investors in the home finance process be sensitive to the possibility that refinancing may be difficult, or that refinancing at an affordable cost may be difficult, in the case of one, two, three, four or five year balloon notes, and that it is really important that people should go into this kind of transaction with their eyes open.

ASSEMBLYMAN PAPAN: In your research, how much money market investing was being done by the savings and loans in advance of the present prices?

MR. ELBRECHT: I don't have those statistics, sir. I know that there was some.

ASSEMBLYMAN PAPAN: Do these statistics indicate how construction has fallen off as opposed to the demand?

MR. ELBRECHT: Oh, it's quite clear that housing construction has fallen off dramatically. We have...

ASSEMBLYMAN PAPAN: How does that impact on the price of homes in the period of refinancing balloon payments?

MR. ELBRECHT: The unavailability of additional homes to meet demand will itself be a factor that will tend to increase real property values.

ASSEMBLYMAN PAPAN: So conceivably the people confronted with balloon payments could be in a market situation where values have a built-in factor of appreciation as opposed to leveling off?

MR. ELBRECHT: There will be forces, as there always are in a market context, going in opposite directions, and it is a question of how these will resolve themselves.

ASSEMBLYMAN PAPAN: Your statement doesn't go into that kind of statistic, does it?

MR. ELBRECHT: No, we don't. That's one of the factors that would bear on what the future would hold. The main point is that if peoples' expectations of continuing inflation and of continuing real estate appreciation are diminished, then that factor itself will have an important bearing on the value of real property. That is essentially the message of the two housing economists.

ASSEMBLYMAN PAPAN: You have no information about how busy the savings and loan industry has been with respect to money markets themselves in advance of this period?

MR. ELBRECHT: We know that they have participated both as lenders and borrowers.

ASSEMBLYMAN PAPAN: Do you have any statistics? These are the things that I think your department and I think Mr. Spohn... There are many people who understand what the statement is, but the specifics are something the Department should engage in more frequently because I still have the vast bad taste of their posturing with respect to Wellenkamp. You guys are so busy selling something to the public that just wasn't true. You've a long way to go as far as I am concerned.

MR. ELBRECHT: We will do our best to gather some of these statistics, sir.

CHAIRMAN BOSCO: I think Mr. Papan's point is one that I have too. Even if people start saving and the savings and loans are able to attract capital, what is to say that they will use it for housing?

ASSEMBLYMAN PAPAN: They'll build new buildings.

MR. ELBRECHT: Well, that's correct. Part of the economic deregulation mode is to deregulate on both the liability side and the asset side, and savings and loans have asked for and have received powers to engage in a lot of economic activity that doesn't have anything to do with housing -- consumer loans, trust services and so on. It may be that when rates are so high that borrowers can't afford to enter into mortgages at 16, 17 or 18 percent, the industry will need these other avenues of investment to simply stay afloat.

CHAIRMAN BOSCO: Well, I know one thing, and I'll ask this when representatives of the industry are before us, but some of the changes in the law that we have been asked to make, at least relative to state chartered institutions are always put into terms of making money available for housing. I think it would be unfortunate if we made some of the changes and found out that the money wasn't available for housing anyway.

MR. ELBRECHT: Well, the Legislature should be on guard against that possibility. It's likely, in fact, that the savings and loan industry will be branching out into additional areas, and housing will have a lower priority, at least until inflation is dealt with -- cured -- and interest rates are back down to the point where people can afford to enter into home mortgages.

ASSEMBLYMAN MCALISTER: I have noticed that the recent tax legislation that was passed apparently contained provisions that are hoped will encourage the savings and loan industry -- all all savers certificate. I'm reading from a Wall Street Journal article. It says, "...institutions could pay 70 percent of the interest rate on one-year Treasury Bill. This would probably attract funds from six-month savings certificates. Savers could exclude from their taxable income as much as $1,000 in interest earned on the proposed certificates, or as much as $2,000 per couple filing joint returns." It's not quite clear. Was this part of the bill that was just passed?

MR. ELBRECHT: That's correct.

ASSEMBLYMAN MCALISTER: What do you think that will do insofar as attracting money away from the money market funds and back to the lenders who lend money on residential real estate?

MR. ELBRECHT: It's very controversial. I know that some of the members of the Federal Reserve Board have expressed the view that it won't have much positive impact on the volume of new savings going into the savings and loans, that it will primarily result in shifting from one kind of savings instrument to another. On the other hand, only the future will tell. I think there is a lot of controversy on the question. A lot of people at the federal level opposed it on the ground that it was very costly in terms of the federal budget, increasing the federal deficit while at the same time providing relatively marginal benefits to the home purchasers and the home construction industry. So, there is some skepticism about the extent to which that program, which is a very costly federal program, will actually resolve in additional housing. But it's impossible to say...

ASSEMBLYMAN MCALISTER: If I'm not mistaken, I think the Wall Street Journal, itself editorialized against this...

MR. ELBRECHT: That's right, the Wall Street Journal opposed it, and I believe Mr. Diehl, also, spoke in a recent article that was reported in the Wall Street Journal indicating that he had some questions about it's actual impact on the market.

ASSEMBLYMAN MCALISTER: It seems to me there's a real clash of opinions here as to the future so far as whether the cost of housing is going to continue to appreciate. You've got this fairly new school of economists who are inclined to think that the appreciation is about at an end and may even go down and some of those folks in fact even think that we're going into a depression. But on the other hand, we've had kind of a period here of two or three years now in which there has been relatively little construction. We have a huge pent up demand for housing. We have a lot of the young people who've been going into apartments or into homes that were too small for them. We've had relatively little construction. If you look around a little bit you still find a lot of homes that contractors built that they can't sell. Those fellows are really hurting, but the volume of construction has gone down. At some point this is going to be like a dam that's going to burst. I mean you've got all these flood waters. I recognize all the deflationary factors, but there are still people in the country who have to live in houses. The total number of households in this country is increasing at a fairly good clip, not because of population increase so much as due to the smaller households. This means that housing is still going to keep appreciating rather than depreciating.

MR. ELBRECHT: Well, this pent-up demand is surely a demand, but to make it an effective demand requires that the people who demand have the wherewithal to make the payments on the mortgages. And that is probably the major constraint -- the financial capacity of the people who are demanding the housing. So, assuredly, the demand is there. Whether it will be an effective demand, whether it can be translated into an effective demand through available credit as a cost people can afford, is the great unknown question. That in turn will depend upon dealing with inflation and getting interest rates down.

ASSEMBLYMAN MCALISTER: I mean all this money that's going to go apparently into reindustrialization, is, I guess, supposed to make the economy go, and people are going to be working for these industries and so forth, but these people are going to live somewhere. There is a significant number of them that aren't going to be satisfied to either live in a tent or in an apartment house.

MR. ELBRECHT: That's right, there is going to be an enormous demand for housing, of a kind that we haven't seen. The challenge is really to develop and create housing and provide housing finance of the kind that will enable people to actually realize their demand and acquire housing. And there's a tension there that will be a challenge for the state and for the housing sector to meet.

ASSEMBLYMAN COSTA: The estimates are 300,000 units a year for the next five years in California. Last year we built 144,000 units.

ASSEMBLYMAN PAPAN: Can I ask you a very easy question? Tell me what usury is?

MR. ELBRECHT: Usury refers to a law that limits the interest or finance charge or service charge that a creditor can impose.

ASSEMBLYMAN PAPAN: Absent the law, what is usury?

MR. ELBRECHT: Nothing. Usury refers to a legal restriction, it does not refer to simply a moral or an ethical...

ASSEMBLYMAN PAPAN: Let me ask you sir, historically, because I always like to take you away from your statement. If Mr. Spohn were here I'd enjoy it a little more. How did we arrive at a limit one time of 10 percent and anything above that as being usurious?

MR. ELBRECHT: Well, people believed that if you pass a law that limits the amount the creditor can charge, it will cost less for the credit.

ASSEMBLYMAN PAPAN: People believe? Let's talk in facts.

MR. ELBRECHT: And in fact, legal rate ceilings, depending upon the market, do limit what the creditor can charge. This originated...

ASSEMBLYMAN PAPAN: What is your opinion of this, since you're heading a department on presumed salary, what is a usurious rate in number? Forget there is no law now because we've lifted the lid.

MR. ELBRECHT: Inflation really wrecks all systems of legal restraint on interest rates, because of the disorientation.

ASSEMBLYMAN PAPAN: Let me ask you, in the event they can't lend the money, what do you think will happen to the interest rates or they are limited in lending it?

MR. ELBRECHT: If there are interest rate ceilings, which of course there aren't in the home mortgage area. With Prop. 2 we've eliminated rate ceilings, not only for the banks and savings and loans, but also for loans made or arranged by mortgage loan brokers.

ASSEMBLYMAN PAPAN: Let's get back to the first one. What do you think the interest rates should be in law, so that we can say it is no longer usurious?

MR. ELBRECHT: In general, in a competitive...

ASSEMBLYMAN PAPAN: Not general, I want specifics.

MR. ELBRECHT: In a competitive market where there is effective rate competition and that in turn prevents...

ASSEMBLYMAN PAPAN: I don't want to listen to this, what in your opinion...do you have any opinions at all besides what you want...to give us textbook answers.

MR. ELBRECHT: This is a very definite opinion...

ASSEMBLYMAN PAPAN: Give me a number at the end.

MR. ELBRECHT: ...where there is competition, effective competition on rates, you don't need rate ceilings.

ASSEMBLYMAN PAPAN: Give me a number now!

MR. ELBRECHT: Zero, you don't need any law at all. There's effective rate competition, so that lenders compete among...

ASSEMBLYMAN PAPAN: Then you supported lifting the 10 percent limit that we have in law, is that what you're telling me? Arbitrary as it was? I don't want to lose sight of the fact that at some point these interest rates are usurious. I presume that with this kind of statement that you've read very well that you have some opinions yourself.

MR. ELBRECHT: I think we raised some questions about totally eliminating rate ceilings for second mortgage loan brokers. As far as the ten percent ceiling, that was obviously too low and we supported a change.

ASSEMBLYMAN PAPAN: I'm going to try to get a figure from you and I'm going to die trying.

MR. ELBRECHT: I'm going to try to answer your question, sir!

ASSEMBLYMAN PAPAN: What, in your opinion is a usurious rate?

MR. ELBRECHT: If...

ASSEMBLYMAN PAPAN: I'm lending you money, when would you like it and not call me...what were money lenders called in the old days?

MR. ELBRECHT: Charlatans?

ASSEMBLYMAN PAPAN: Loan sharks is a common word.

MR. ELBRECHT: This is going to sound evasive, but a rate that unconscionable.

ASSEMBLYMAN PAPAN: What is a rate that is unconscionable?

MR. ELBRECHT: It just strikes your conscience as being ridiculously high.

ASSEMBLYMAN PAPAN: Do you have any at all? What is the... it or particular feelings.

MR. ELBRECHT: I would say this. On a refinancing of a second mortgage loan or...

ASSEMBLYMAN PAPAN: No, don't say...I'm asking you in a first -- forget refinancing and the terms.

ASSEMBLYMAN MCALISTER: (Inaudible)

ASSEMBLYMAN PAPAN: He's going around in circles here. I just want one figure in his mind that maybe we should reduce into law to stop all of this.

ASSEMBLYMAN MCALISTER: But there are a lot of people that are loaning out on seconds, so there might be a...

ASSEMBLYMAN PAPAN: You want to make that distinction and get to the primary lender, fine.

MR. ELBRECHT: If there is no inflation, 18 percent sounds pretty high.

ASSEMBLYMAN PAPAN: On a second?

MR. ELBRECHT: Well, you asked me for a single figure. If we're talking about a noninflationary environment, 18 percent is a good rate ceiling.

ASSEMBLYMAN PAPAN: That's a good ceiling?

ASSEMBLYMAN MCALISTER: Isn't that the Unruh Act ceiling on...

MR. ELBRECHT: Which, however, you don't need if there is a competitive...

ASSEMBLYMAN PAPAN: What's wrong with 12 percent? It's obvious that lifting that ceiling is causing us havoc. If everybody has to lend within certain perimeters I think, I think we'll eliminate some of property and when we do set the law.

MR. ELBRECHT: The problem with a 12 percent rate ceiling is that if inflation is 15 percent, the lender has a negative return and lenders aren't going to lend.

ASSEMBLYMAN PAPAN: The way they reacted to that was prepaid interest which was in the form of a loan fee.

MR. ELBRECHT: Well, that's funny business that should perhaps be...

ASSEMBLYMAN PAPAN: What do you mean, funny business?

MR. ELBRECHT: That's interest in another guise.

ASSEMBLYMAN PAPAN: That's their reaction to the inflation. They'll get some prepaid interest in advance. Let me ask you, do you support us setting into law a limit as to what you can lend?

MR. ELBRECHT: In the real estate market today, no!

ASSEMBLYMAN PAPAN: How could you say that? Look what we have here! I'm saying that...

ASSEMBLYMAN MCALISTER: How does that help us?

ASSEMBLYMAN PAPAN: When we had it at 10 percent it didn't affect the lending institutions, and we put 10 percent on it because at some point in time people felt that if it was in an excess of 10 percent it was usurious. Now somewhere we have lost that concept.

ASSEMBLYMAN MCALISTER: Could I ask a question here, Mr. Elbrecht? Before we passed Prop. 2 second mortgages could only be at 10 percent, right?

MR. ELBRECHT: That's correct.

ASSEMBLYMAN MCALISTER: Well, who in the world in their right mind would finance a second mortgage today at 10 percent.

ASSEMBLYMAN PAPAN: Mr. McAlister, if we proceeded, sir, to limit the 10 percent to everybody or go to 12 percent and lend...

ASSEMBLYMAN MCALISTER: Who would do that?

ASSEMBLYMAN PAPAN: We do it in law.

ASSEMBLYMAN MCALISTER: Well, so what? I mean you'll put your money in Eurodollars...

UNKNOWN VOICE: In Reagan dollars! (Laughter)

ASSEMBLYMAN MCALISTER: There's a million places to invest your money if you're going to put that kind of limitations on it.

ASSEMBLYMAN PAPAN: Placing that limitation on it, I think, would cause a situation to evolve where most people would not proceed to seek the higher interest.

MR. ELBRECHT: There is no doubt that rate ceilings do have some impact on the market in most cases.

ASSEMBLYMAN PAPAN: No question, and when we lifted the ceiling this is what we got.

MR. ELBRECHT: There has certainly been a trend in the last few years of simply letting interest rates go wherever they will, and assuredly, when we experience some of the twenty and thirty percent rates that we're going to be hearing about when it comes to refinancing the ballon-payment mortgages that we're talking about here today, we are going to wonder whether that was really a wise decision.

ASSEMBLYMAN PAPAN: Let me tell you sir, I envision that a lot of lenders in our country that were very solid institutions are being threatened by the fact that we opened a situation up here by lifting that arbitrary limit that we had. Greed has set in. You know that money lenders were considered very greedy people. And I think that it's time we reexamine what we've done to ourselves and find another arbitrary level that begins to bring some sanity to this business of lending money or paying for money, at least in this state, and maybe nationally, maybe that would be the answer.

ASSEMBLYMAN MCALISTER: Now, if you do that what do you think these people who are lending this money are going to do with their money? I mean think that if inflation is above the level that you said, what are they going to do with their money?

ASSEMBLYMAN PAPAN: Probably put it into property or find other outlets. But the cost of money...

ASSEMBLYMAN MCALISTER: Buy gold, maybe? Gold? Paintings, precious art, antiques, old books?

ASSEMBLYMAN PAPAN: There will be some of that, but there won't be the kind of chaos that we have now.

MR. ELBRECHT: The first order of business is dealing with inflation, and a lot of the other problems will be resolved almost automatically if we get inflation down to a zero level.

ASSEMBLYMAN PAPAN: You don't think these high interest rates are inflationary?

MR. ELBRECHT: They are inflationary; but they are a result of inflation.

ASSEMBLYMAN PAPAN: If borrowing stops for any reason and the cost of money gets so prohibitive the chances are that you'll find a leveling off and possibly a drop in the cost of money. Can we afford to buy that kind of risk or do we have to act now to impose an arbitrary limit to what you can receive and what you charge for the cost of money?

MR. ELBRECHT: If you do establish limits, creditors will go elsewhere to make their investments.

ASSEMBLYMAN PAPAN: I've heard that argument.

MR. ELBRECHT: I don't want to argue too strongly against ceilings because we do support them in certain cases.

ASSEMBLYMAN PAPAN: Have all states lifted the limits?

MR. ELBRECHT: Several states have deregulated in the consumer credit area. Federal legislation has deregulated rate ceilings in real estate finance across the board.

ASSEMBLYMAN PAPAN: But the loosening up of what was once an accepted level has caused us to have the kind of situation that none of us wants. And I think we as a governmental body, Mr. Chairman, should reexamine and probably encourage the federal level of government to proceed at least for a period of time to set an arbitrary limit to the cost of money.

ASSEMBLYMAN MCALISTER: Lou, you're talking about a national phenomenon, of course, you're not talking just about the State of California phenomenon. I don't think that the passage of Prop. 2 has had anything to do with the basic problem that we're talking about.

ASSEMBLYMAN PAPAN: You know, but if there is an interest, Mr. McAlister, in the kind of situation that we have, and there is a national interest, I don't know that the money lenders -- I mean the lending institutions of our country, all of them would be in agreement on this point. But I can tell you my concern is for the source of money that went into homes that came from savings and loans that presently are in some serious trouble and conceivably could cause a greater harm. Hopefully that does not occur, but there have been some pretty shaky ones across the country. It's time that we set an arbitrary limit, and if everybody has to live within those limits you'd be surprised how things would change.

MR. ELBRECHT: Actually, the U.S. Savings and Loan League is involved in litigation at the federal level to prevent the Deregulation Committee from proceeding as fast as it has wanted to proceed. So, actually, the U.S. Savings and Loans League is in at least in some agreement with some of the things that you've said, Mr. Papan.

ASSEMBLYMAN PAPAN: You call it deregulation and I call it tolerating usury.

ASSEMBLYMAN MCALISTER: I recall the two principal exponents of the usury concept in history were the medieval church and people like Ayatollah Khomeini. And in the Moslem countries, of course, I think they largely engage in a hypocritical device to avoid...

ASSEMBLYMAN PAPAN: Did you ever try to find a house in Moslem country?

ASSEMBLYMAN MCALISTER: The closest I ever came to a Moslem country was when I visited Israel and briefly touched base in Lebanon. But I think they largely engage in hypocritical ways of charging interest without calling it interest, but those are the areas. The medievel church has long ago changed its views on that.

CHAIRMAN BOSCO: Now they are right in with the rest of them. (Laughter)

ASSEMBLYMAN MCALISTER: Well that was before the Protestant Reformation, Catholicism and the emphasis that the church, both Protestant and Catholic, eventually came to place upon capitalism, the work ethic, and so forth. I think you've got to go back around the year 1400 or 1500 to get into the strong anti-usury feelings. There is a feature here though that I would like to explore for just a moment. There are those who say, and I'm not defending this, that the high interest rates are partially off-set by the fact they are deductible. If you are in, for instance, the 30 percent bracket, the 15 percent interest is of course, is equivalent to only 10 and a half percent because you're deducting four and a half of those 15 points on your federal taxes plus of course whatever state taxes would exist.

MR. ELBRECHT: By all means, our federal and state tax policies have fostered higher interest rates than would otherwise be the case as the result of the deductibility of interest and the includability in gross income of interest income. Both of those policies working together have assuredly increased the prevailing interest rates, and that is a matter of government policy at both the federal and state level.

CHAIRMAN BOSCO: Could I ask you to summarize the balance of your testimony because I would like to try to keep on schedule and we do have a copy of...

MR. ELBRECHT: Well, maybe I should move into the Wellenkamp issue because Mr. Papan specifically wanted me to do that.

CHAIRMAN BOSCO: And I'll ask Mr. Papan to summarize his remarks as well.

ASSEMBLYMAN PAPAN: And then close with Mr. Elbrecht's summary.

MR. ELBRECHT: Now that real estate values are beginning to stabilize, at least in real inflation-corrected terms, and with the risks of creative financing better understood, it may be the time to begin focusing more carefully on the design of tomorrow's home finance process. That includes the design of alternative mortgage instruments, as well as the exploration of new sources of finance.

One design feature of the home finance process that is of critical importance, and that is a particular need of careful scientific analysis, is the actual term or duration of the home mortgage loan. As noted above, financial institutions have begun to make short-term first mortgage loans with balloon payments due in some three to five years. They have done this, they have said, because of the extraordinary risk of future interest rate increases which they were unwilling to sustain. At least three factors have played a role in their decision to utilize a form of lending that was the norm before the great depression. One is their perception of the inadequacy of the present limits on interest rate changes in adjustable rate mortgages. The second, is the absence of a secondary market for adjustable rate mortgages. The third, is the ruling in the Wellenkamp decision that makes it impossible to limit the term of the mortgage to the duration of the borrower's ownership of the property.

All these issues must be addressed scientifically and competently in order to provide financial institutions with the legal context and opportunity that will enable them to participate in the long-term home finance process and to do what they can to help meet the home purchase credit needs of those consumers who do not already own their own homes as well as those who are faced with a balloon. During the past several weeks the national secondary market adjustable rate mortgages has been opened for the first time. And it can be anticipated that legislation will be adopted in California that will allow California chartered institutions and home mortgage borrowers to participate in the new adjustable rate secondary market.

The remaining issue is the term or duration of tomorrow's mortgages, and the effect of the Wellenkamp decision on the future home finance process. This has become one of the most controversial questions this session.

ASSEMBLYMAN COSTA: I think we are aware of that.

MR. ELBRECHT: At the outset...

UNKNOWN VOICE: Some of us more than others. (Laughter)

ASSEMBLYMAN COSTA: That's correct!

MR. ELBRECHT: It is important to make a distinction between the design of mortgage instruments for use tomorrow, and the rights and obligations of lenders and home mortgage borrowers under mortgages made yesterday and in past years. The subject that we wish to address is mortgage instrument design, the crafting of tomorrow's home finance process. There is a mutuality of interest among lenders and consumers in formulating workable rules that will allow homes to be built, purchased, financed, and occupied. Unless workable rules are fashioned, tomorrow's consumers, our children and others, and ourselves when we move, will not be served.

The issue concerns assumability of mortgages. If the mortgage is assumable, a subsequent buyer can purchase the property without having to procure a new first mortgage loan. The buyer can assume or purchase the property subject to the existing mortgage, paying the difference between the loan balance and the agreed purchase price to the seller, either in cash or by means of second-lien note or deed of trust or a combination. The entire unpaid balance under a mortgage that contains a legally enforceable due-on-sale clause is due upon any sale of the property.

There are basically two ways in which a mortgage may be assumable by the purchaser. The mortgage itself may have no due-on-sale clause, and in that event, the duration of the mortgage will depend on the term of the loan, whether one year or five, ten, twenty or thirty years or longer. In that kind of a mortgage, a sale will not result in a termination or acceleration of the loan. And a new buyer will be able to assume or purchase the property subject to such mortgage.

A mortgage may also be assumable even if there is a due-on-sale clause declaring that it is not. The due-on-sale clause may be legally unenforceable in the context of an ordinary sale of the property -- if the mortgage is made by an institutional lender to an ordinary purchaser. That is roughly the present California rule as articulated by the California Supreme Court in the case of Wellenkamp vs. Bank of America. That rule in effect says that all mortgages are assumable.

In deciding whether the present California rule should remain in effect -- that is, whether California law should require that in the future all newly made home mortgages must be assumable by subsequent buyers -- it is important to identify the relative importance and true value of assumability to the buyer who procures and pays for such a mortgage, and then to assess the costs that are likely borne by such buyer in exchange for the assumability feature. Like most benefits that the law requires one private individual or firm to confer on another, the consumer benefits from what is required, but the consumer, or consumers generally, usually pay a little more as a result, or the property or service to which the benefit is attached is no longer provided in the market.

In the case of mortgage assumability, the homeowner who is able to procure an assumable loan clearly has something of value because of that fact. Other things being equal, an assumable loan is a better loan from the consumer standpoint than a loan that is not assumable. But in exchange for the assumability feature there are costs and burdens which the person who procures and pays for an assumable loan must beat and in the future may be required to bear to a much greater extent than before. In short there is no free lunch.

It is important then to identify these costs and burdens, and to attempt to measure their weight before reaching a decision on whether California law should continue to require that mortgages must be assumable. There are a variety of other mortgage contract terms in addition to assumability that are of equal and probably greater importance to the ordinary consumer.

One obvious term is the actual cost of the mortgage, the mortgage contract interest rate. Indeed, the interest rate is probably the most important mortgage contract term of all, because it in turn determines the amount of the monthly payments, or, in some proposed mortgages, the amount of the owner's net proceeds following sale.

Another important mortgage contract term is the duration of the mortgage. Mortgages can be of any term, whether one year, five, ten, twenty or more. If the duration is only five years instead of thirty years, the buyer who assumes an assumable mortgage will only enjoy the benefit of the mortgage until the expiration of the five year term. Assumability does not mandate that the mortgage remain in effect beyond its stated term, only that it is not due upon sale.

Another important mortgage contract term is the possibility of, and especially the limits on, interest rate variability. A buyer who procures or assumes a mortgage whose interest rate floats with the market without limits in effect commits himself or herself to pay current market interest rates all the time. And a buyer from such a person will gain nothing from assumability other than an assured source of credit.

The interest rate adjustability clause, if present, may be more important than the initial interest rate itself.

A buyer who values assumability can expect to pay something for the assumability option in terms of either initial interest rate, or a shorter loan term, or a greater range of variability in the interest rate with perhaps no limits at all, or some combination of each of these. That is because the assumability feature increases the lender's risk, and lenders will seek compensation for the extra risk or require some sort of a hedge against the losses that may result. Another possibility is that lenders will conclude that it is simply too risky to make home loans and will withdraw from the market.

Assumability increases the lender's risk because few purchasers remain owners for as long as thirty years. People move frequently -- on the average about every five years. Prior to the Wellenkamp decision, California mortgages had an average life of some seven to twelve years. Hence, while the buyer has an option to remain owner under the same loan for as long as thirty years, the fact that the loans were due on sale meant that the average maturity of the home mortgage loans in a lender's portfolio was considerably less. That in turn reduced the lender's overall risk.

By increasing the probable average duration of home mortgages from seven to twelve years, to fifteen or twenty years or more, assumability as mandated by the Wellenkamp decision has radically increased the lender's risk that increases in market interest rates will lower the relative yield on its mortgage loan portfolio to the point where it will not have funds sufficient to pay competitive rates to its depositors. If and when that happens, depositors withdraw their funds.

Looking to the future, it appears that lenders, to protect themselves, will attempt to compensate for and hedge against the additional risks resulting from the assumability of home mortgages, which is now mandated by the Wellenkamp decision, and at times will withdraw from the long-term home finance market.

One possible, indeed likely, response to a continuation of legally mandated assumability in California, will be somewhat higher interest rates. Lenders and investors in the secondary market will seek a higher return, if they can, in exchange for the greater risk. A more likely, indeed certain, response by lenders to a continuation of mandated assumability in California will be shorter loan terms -- for example, three-year to five-year roll-over mortgages without a provision for refinancing.

Another equally probable response to a continuation of legally mandated assumability in California will be a greater proliferation of adjustable rate mortgages in which there is little or no restraint on changes in the contract interest rate. If mortgages continue to be assumable, lenders will not feel secure against major long-term changes in market interest rates unless the mortgages provide that their interest rates will float with the market. Lenders will be more hesitant about making fixed rate mortgages, or adjustable rate mortgages with reasonable caps on changes in the interest rate. If assumability is mandated, uncapped adjustable rate mortgages are more likely to become norm in tomorrow's home finance market.

Consumer interests have consistently opposed mortgages with little or no restraint on changes in the contract interest rate. It would be tragic and ironic if, in an attempt to preserve assumability, the more important issue of interest rate variability, and the importance of limits thereon, were forgotten.

From the perspective of the individual home mortgage borrower, the buyers main interest is in the procurements of the credit needed to purchase and own a home at a cost that is affordable in both the short and long term. If the loan is good for only five years, or if it costs more it should, or if the cost could increase dramatically as a result of changing economic conditions, those are features most consumers would deem worth avoiding even at the cost of losing the assumability feature. Few consumers, we feel, would want to preserve assumability at all costs.

While the right and opportunity to sell one's home is important, it must be considered along with the right to own and live in one's home without confronting the need to refinance after five or seven years or to risk having to pay extraordinary increases in the interest rate. While both are important, it seems clear that the principal focus should be on the design of a mortgage instrument that is affordable during the period when the owner is living in the house.

ASSEMBLYMAN PAPAN: In your statement so far, you have not stated if that particular lender wanted to stay on the loan and increase the amount as an option he would have at the market place, rather than be penalized for extending the same loan to a new buyer.

MR. ELBRECHT: Well, our recommendations on Page 19 are that instead of making the entire unpaid balance due upon sale, perhaps the mortgage should give the new buyer an option to take over the existing loan, and should give the lender the option to increase the interest rate upon transfer to the lender's then current mortgage contract interest rate. That is one of the suggestions we proffered to the committee.

CHAIRMAN BOSCO: Sort of a blending?

MR. ELBRECHT: That's correct.

CHAIRMAN BOSCO: I think that your testimony is almost over now, but the thing that I am really interested in and perhaps your department could develop or maybe some of the other witnesses is this, and I think this is probably the basic question that the committee has to look at. First of all, for the average person that assumes a loan, what is the average assumable part of that loan, like is it 40 percent of the whole purchase price on an average 50 percent -- we know that it is only some percentage of what the total cost is. And then, what happens to the average consumer in the market place on the rest of that credit? What do they have to pay for the rest of that credit, because what I'd like to know, is are we better off ending assumability of loans and requiring the people to get new loans at X amount of interest from the savings and loan or bank or mortgage broker, and would an average person be better off doing that than assuming the loan and having to get very expensive interest and maybe being worse off in the end financially.

MR. ELBRECHT: Well, what we would commend to the Legislature...

CHAIRMAN BOSCO: I would like to know the facts on that, you know, what is happening, factually, because what you have given us is more or less the theory behind all this, and that is valuable, but it is something that the committee is pretty much aware of.

MR. ELBRECHT: Right. Well, the consumer who assumes a loan will typically execute a second mortgage as part of a creative financing type of arrangement to pay the difference, and perhaps add some additional cash in the transaction. We are not suggesting...

ASSEMBLYMAN PAPAN: Lending out at the higher interest rate at the expense of someone else, is that what you are saying?

MR. ELBRECHT: I say, this is what consumers are doing today.

ASSEMBLYMAN PAPAN: Most secondary financing is at a higher interest rate, so that people who are advancing that money are strongly supportive of the continuation of that Wellenkamp decision. Nobody is benevolent enough to say in view of the fact that there is a big first on it, and the seller who owns that property adds a premium to the sales price to that house, because he's got a great first loan, and then the broker -- the real estate broker -- who enjoys six percent of the $200 thousand level, he's going to squawk about doing anything that would modify that schedule or anything that would modify that assumability of an existing loan. And in many instances, finds a secondary market that goes somewhere between 18 and 21 percent as a convenience to the prospective purchaser of that house. These terms, I think, should always be clarified.

CHAIRMAN BOSCO: Well, the public is under the impression that assumable loans are a good thing because you get into a new house easier and you pay less interest, but what I am asking is, in fact is that true. Could it not be true that the average person really gets bilked by this type of a situation because although they may have a lower interest assumable, they end up by necessity getting a much higher interest loan to make up the difference and, therefore, are really worse off than they would be if we ended assumable loans.

MR. ELBRECHT: In many cases, the seller who owns property with an assumable loan will be, in taking back the secondary financing, charging a higher rate...

CHAIRMAN BOSCO: ...and in addition...the seller will charge more for the home to begin with because it has an assumable loan...

MR. ELBRECHT: I want to clarify one point though, Mr. Chairman. We are not suggesting that the rights and obligations of the lenders or borrowers under mortgages that have already been made be affected. We are talking about crafting mortgages for use in the future. We are talking about tomorrow's mortgages. We are talking about mortgage instrument design, and our suggestions to the Legislature that that assumability not be part of the home finance process refers to new mortgages that are made tomorrow.

CHAIRMAN BOSCO: Talking about the future is something we would all like to have the luxury of, but we have to deal with an existing problem that, at least in large part, deals with what has happened in the past.

ASSEMBLYMAN RICHARD ROBINSON: I think the chairman has a key point. You are suggesting the, that the Wellenkamp decision be in effect for all existing loans?

MR. ELBRECHT: We don't have any position on that point, sir. Our concern is this, Mr. Robinson, that the debate over the past, over the rights of homeowners, borrowers, and lenders, and mortgages made in the 1940's, 1950's, 1960's and 1970's not interfere with the enormously important process of crafting the home finance process tomorrow...

ASSEMBLYMAN ROBINSON: ...(Inaudible) by even that suggestion. Most of that paper includes a due on sale clause provision. I think we are talking about contract rights, that the due on sale provision is included within most of those contracts.

CHAIRMAN BOSCO: You cannot look at the future without the past because these are ongoing instruments that include both.

ASSEMBLYMAN MCALISTER: Mr. Chairman, as I understand it, though, I mean their recommendation is that we not tamper with the past, that we change, in effect, repeal Wellenkamp for the future, that we allow the new buyer to assume the mortgage. However, that's what you might call an administrative assumption. I mean, he is going to get the rates updated to what the rates are now. You are going to limit the cost of assumption to just administrative costs. That, I suppose largely, is kind of a political judgment. It is virtually impossible to affect the past anyway.

MR. ELBRECHT: That is the focus of the controversy surrounding the Wellenkamp decision.

ASSEMBLYMAN MCALISTER: Members of the Legislature, among others, are keenly aware of the controversy that this has aroused and the fact that it is very difficult politically to take something away from people that they have. Vested interests of any kind are almost impregnable.

MR. ELBRECHT: Actually, sir, this statement is a plea not to let that controversy prevent the Legislature from acting constructively in terms of crafting tomorrow's finance process. And our department has concluded that for tomorrow, assumability is not in the interests of the consumers, and therefore that's why we are suggesting that the Legislature consider modifying the Wellenkamp decision prospectively only.

ASSEMBLYMAN ROBINSON: You are walking a very narrow line there. You are talking about hundreds of billions of dollars that are tied up in this paper. That has been a windfall. That money is not going to be freed, and so therefore we are not going to resolve the housing problem. You talk about interest rates, and I disagree with Mr. Papan's assumption, but you are certainly talking about the supply of the funds that are available for the housing. Without that supply being there, you haven't solved anything. You might mislead a lot of these young newlyweds that there is going to be money available, but that money is not available because it's tied up. I mean, you have to understand the whole...

ASSEMBLYMAN PAPAN: ...the practical side being that present homeowners are working a hardship on the young who are trying to find homes.

ASSEMBLYMAN ROBINSON: Present homeowners are being subsidized by the young couples who are successful in finding homes. Mr. Papan and I were just comparing notes. We both have old mortgages around eight and nine percent. We are being subsidized by the young newlywed who goes out and buys a home at 16, 17 and 18 percent...

ASSEMBLYMAN MCALISTER: There is no question...I have been looking at some homes myself recently, and I can see what assumability does, and how it can be a factor in buying and selling homes. However, I have to say that assumability becomes a much bigger factor insofar as a benefit to the buyer, the larger the loan is, that you can assume... If you are talking about buying a $200 or $250 thousand house with a $30 or $40 thousand assumable mortgage, that frankly doesn't mean a great deal. If you have an $80 or $100 thousand mortgage that is assumable at eight or nine percent that means a great deal. But of course, as time has gone by, one would suppose that assumability becomes less and less important on those old loans, at least if you assume the continuation of inflation. I mean if you double the value then, what all of these recession oriented economists say is not going to happen. If you were to increase the value of existing residences even by 30 or 40 percent, how important is it to anybody that there be assumability...

MR. ELBRECHT: Surely, the old assumable loans are going to become less and less important as real property continues to appreciate in nominal terms, and also as creative financing, perhaps when people begin to look at it a little more carefully, isn't as readily available as it has been in the last two or three years. As a result of some of the cautions that we are expressing here today, if the people take account of them I think that people will be a little more careful either as lenders or borrowers, in utilizing three-year, four-year, five-year balloon-payment notes. I think that as Mr. McAlister has indicated, the Wellenkamp issue, in terms of mortgages already in existence, is going to recede in importance. Many of those loans will be repaid when owners procure new financing, new financing under either new fixed-rate mortgages or adjustable-rate mortgages made by lenders tomorrow.

CHAIRMAN BOSCO: Mr. Elbrecht, I would like to thank you for your testimony...

ASSEMBLYMAN PAPAN: Let me ask him just for the record, too, Mr. Chairman. Did not Consumer Affairs come out against the Foran bill that would have modified the Wellenkamp decision?

MR. ELBRECHT: We opposed it. The Foran bill did not modify the Wellenkamp decision. I am not aware that we were ever involved in the Wellenkamp issue prior to today. We did oppose the Foran bill on the ground that it was premature and I think events have indicated that it was. It is not an instrument that would have been usable in the secondary market...

ASSEMBLYMAN PAPAN: Has it grown to maturity in the opinion of the Department now?

MR. ELBRECHT: Not the Foran bill, but certainly adjustable-rate mortgages with the proper lender and borrower safeguards, yes...

ASSEMBLYMAN COSTA: We are talking about two different issues. Which one...(Multiple voices).

CHAIRMAN BOSCO: Well, if today represents your first involvement in this issue, I would suggest that you are a little bit late, because it involves a lot more controversy than I think your Department is willing to handle, at least in the statement you just made, Mr. Elbrecht.

ASSEMBLYMAN COSTA: I would like to take off on that, and that is as representing the Department of Consumer Affairs, and I think our concern with the committee here is with the consumers, those owners of homes -- the sellers of homes and hopefully, the potential buyers of new homes, the young families that we are concerned about in this state.

You have described the problem well, but we all know what the description is and your solution for the future is, I think, probably in agreement with what we think is going to have to take place, but you haven't told us as head of the Department of Consumer Affairs, what do we do next year about people that have these balloons come due on the principal that aren't able to make the payments, that aren't able to get refinancing? As the protectorate of the consumers out there, what are your suggestions and the Department's suggestions? What are you thinking about as to how we protect those consumers?

MR. ELBRECHT: We were looking forward to these hearings, and to what other witnesses would say. We would be very delighted to offer our views. We would like to utilize these hearings as factual input into our thinking. We have several ideas, and I would like to listen to the other witnesses today before proposing specific action.

ASSEMBLYMAN MCALISTER: Could I just ask a question? Why have we gone to thirty year loans? If you look at your tables on paying off loans, you only pay about 15 percent a month more on a loan of a given amount, on a fifteen year loan, than you do on a thirty year loan, and yet you pay enormously more interest over that thirty year loan. Why have we done this?

MR. ELBRECHT: These are simply steps to try to reduce the monthly payment, and, of course, as you move from twenty to twenty-five years, the reduction in the monthly payment becomes less, and as you move to thirty years, it becomes even less, and if you are talking about increasing the loan term from thirty to forty years, it results in a miniscule reduction in the monthly payments. Now we are talking about negative amortization.

ASSEMBLYMAN PAPAN: Mr. McAlister is leaving the impression that it is totally ridiculous...fifteen, maybe eighteen years ago, most mortgages were seventeen years, and with the increase in the value of property, they went to twenty years, twenty-five years, to thirty years. I think we are fast approaching the time to lift the restriction to something longer, because most buyers are concerned with the amount of the monthly payment. Any attempt to read a deed of trust that lawyers drew up, most people would never understand. The basics of it is -- what does it cost me per month to move into that house?

ASSEMBLYMAN MCALISTER: Look at your tables. You extend it beyond thirty years, you haven't reduced the payments enough to make a bit of difference.

ASSEMBLYMAN PAPAN: But the inflation offsets what you are not amortizing. Those people buying houses with thirty and thirty-five year loans, if they bought them five years ago, the appreciation on that property would more than offset what he is not being credited with on the principle.

ASSEMBLYMAN MCALISTER: And so he can borrow more money?

ASSEMBLYMAN PAPAN: Why, of course. And they are doing that. At one point, we had a real traffic going where an equity seller was buying a new house, and we have facilitated the construction of homes sufficiently...San Jose, I think, and Sacramento were two areas that were keeping up with the market and in many instances exceeding the demand of that market. We have since, together with the private public segment, worked against the construction of new houses. We have proceeded systematically to accommodate the giant lending institutions by lifting any limits that we have on the cost of money, and we have, I think, frankly, Mr. McAlister, proceeded to mislead the public right down the line with the help of the Consumer Affairs Department.

CHAIRMAN BOSCO: Okay, Mr. Stirling, and then I am going to ask that we go on to the next witness.

ASSEMBLYMAN STIRLING: I just want to underline, Mr. Elbrecht, as I understand your line of reasoning, it is that in crafting the future mortgage instruments, we have to get on with one that is at least sane and can be turned over and will attract capital.

MR. ELBRECHT: Yes sir.

ASSEMBLYMAN STIRLING: And that will be the cure for the balloon payments that are going to be coming due next year or the year after that.

MR. ELBRECHT: It will be a partial cure...

ASSEMBLYMAN STIRLING: I essentially understand. I think your testimony has been essentially sound this morning. The question I keep asking is what about those balloon payments which are going to start popping this year and next year? Is there going to be a need for foreclosure moratoriums and that sort of thing, and what is it you are proposing, and your answer is...

MR. ELBRECHT: We haven't addressed that yet, but one possibility would be a provision of law that would allow the homeowner borrower to continue the existing payments at the then current interest rate when the balloon comes due. In effect, the holder of the balloon payment mortgage would not have the right to foreclose, but would have a right to a continuation of the existing payments -- perhaps at the same interest rate, or perhaps at an interest rate that reflected the current economic conditions. That is simply an off-hand answer to your question. There are other possibilities, I am sure, too.

ASSEMBLYMAN STIRLING: My understanding that since the primary thrust of the hearing is to really get down on the negative possibilities of creative financing, I would appreciate it if the rest of the witnesses, rather than relitigating and redebating the theories of rent control and interest control would focus in on the short term, near term, and the long term solutions to...

CHAIRMAN BOSCO: You take the practical approach to what do we do right now.

MR. ELBRECHT: We were asked to try to describe the general context. That is why we have avoided proposing specific solutions.

CHAIRMAN BOSCO: I think, though, that it would be a good thing if your Department could develop some specific recommendations on that because we know it is a freight train coming down the track and we want to have some preparation.

ASSEMBLYMAN STIRLING: One question, Mr. Chairman, the increase in the defaults that are coming up, and as you say, they have increased by about 40 percent which is still below the national average, is that the tip of the iceberg, or are we going to see a much more higher level, and if so, what are the facts to back that up, or does it come up to a certain level and then the sellers and the lenders, rather than foreclosing, are starting to roll them over and make other accommodations?

CHAIRMAN BOSCO: Thank you.

MR. ELBRECHT: We will supplement our statement sir.

CHAIRMAN BOSCO: Thank you, Mr. Elbrecht, very much.

CHAIRMAN BOSCO: We would like to take the next witness out of order. The next person will be Mr. Anthony Frank, Chairman of the Board and Chief Executive Officer of Citizens Savings and Loan in San Francisco. Welcome, Mr. Frank and thank you for being here with us.

MR. ANTHONY FRANK: Thank you, Mr. Chairman, for taking me out of order. I am Chief Executive Officer of Citizens, which is a $3 billion institution headquartered here. I am also Chairman of the California Housing Finance Agency and I am speaking here today for the California Savings and Loan League.

We applaud the fact that this subcommittee is hearing this issue today. We think the matter of creative financing is a ticking time bomb ready to go off, ready to go off for a number of people, some of whom have not been mentioned here today, and that is the investors in these seconds, thirds and fourths, that are being sold as being safe. Further, we haven't heard here today, we've assumed that all creative financing involves a sale, but indeed most of the ads that we see and the emphasis that we see, is on refinancing, what the economists call monitizing one's equity -- get your money out of your house by borrowing against it and then somehow you will be able to pay it back. And to be facetious for a minute, if any member of the committee ever wanted to make three years go by very quickly, the way to do it is to take out a three year second. That due date comes by awful fast.

CHAIRMAN BOSCO: Sort of like having a two-year term of office. Those two years go by very quickly, too.

MR. FRANK: I hadn't looked at it that way.

ASSEMBLYMAN MCALISTER: Chairmans of Boards have only one-year terms.

MR. FRANK: That's very true.

The whole aspect of creative financing rests on two financial foundations. One is the assumability of the old mortgage, the so-called Wellenkamp decision, and the second is the premise that within a short period of time, all of the indebtedness can be recast into a new first. That is the basic flaw that I think we have to deal with here today, because I think that is a supposition that isn't going to come about. I suggest and see that Assemblyman McAlister has today's Wall Street Journal...there are three articles in there that bear on the work of this committee. One is an excellent article on creative financing. Second is an article that indicates that the largest federal savings and loan association in the United States will lose $80 million this year, which after hearing from the realtors and other people about the greed of lending institutions, hardly squares with greed. And lastly, we see on the affirmation from President Reagan this morning that the administration is four-square in back of deregulation for all savings and loans and other lending institutions. I wanted to bring that in perspective for you. We now have the start of deregulation on the liability side, which means that we will be out in the market, we would be today if it weren't for this temporary restraining order in Washington, slugging it out in terms of interest rates on accounts of more than four years, and paying whatever we have to pay in order to get the money. Well, the way that a financial institution gets the funds to pay high interest is to charge high interest. I don't know of any other way to do it. And we are being told by this administration, wrongly, I want to be four-square on that, wrongly I think, that we want you to make any type of loan that you want that the market will permit. If Dupont wants to borrow money and outbid homeowners in order to buy CONOCO, or if Brazil wants to borrow money to pay the interest on the money they already owe and can't repay and is willing to pay a higher rate, then the administration is saying, "We want you to go to the highest bidder and money should seek its own level." That's the so-called Secretary of the Treasury, Don Regan's philosophy of seeking its own level. I think it's wrong.

ASSEMBLYMAN PAPAN: It comes out of the stock brokerage house.

MR. FRANK: Yes, it's basically the ultimate deregulation argument. Let money go to whomever pays the most for it. Now what is going to happen is that savings and loan associations will have two choices, one, they can either make mortgage loans which probably won't yield as much as other investments and they will be able to bid less for funds, and therefore, there will be fewer funds available for mortgage lending; or, they will be permitted to lend on any sort of instrument and we will make higher yields on home mortgages and we will be able to attract funds.

ASSEMBLYMAN PAPAN: Mr. Frank, let me ask you sir, were you lending in the money markets instead of real estate at any point in the last five years and to what extent.

MR. FRANK: No.

ASSEMBLYMAN PAPAN: Were any of the savings and loans doing that?

MR. FRANK: There were one or two...

ASSEMBLYMAN PAPAN: Taking it in at five percent and putting it out on the money market...

MR. FRANK: I understand. There are 178 savings and loans in California and I would say that one or two were doing that.

ASSEMBLYMAN PAPAN: That's all?

MR. FRANK: Yes, sir.

ASSEMBLYMAN PAPAN: You are lending it in the money market. A lot of them...

MR. FRANK: We are what we call arbitraging. Some people were arbitraging. There were very few.

ASSEMBLYMAN MCALISTER: ...money into the money market?

ASSEMBLYMAN PAPAN: They were doing it.

MR. FRANK: Well, that's what some people say. Some people say, well you are being a sucker to lend on mortgages. We think that's our function.

CHAIRMAN BOSCO: Well what you are saying, if President Reagan's decontrols come through, that is probably what your industry will do.

MR. FRANK: Yes. We will have to do. Yes. I think it is very regrettable.

ASSEMBLYMAN PAPAN: Let me ask you, sir. Have any of the savings and loans proceeded to package the low interest bearing loans and accept an offset in order to get it up to a level where a prospective purchaser would accept those in order to better improve your positions and allow you the chance of capturing this higher interest?

MR. FRANK: There has been very little of that and the reason is that it is interesting but a technical one, and that is that when we sell assets at a loss, we take the loss all at the time of sale.

ASSEMBLYMAN PAPAN: How you measure the loss? If the life of that loan were five or seven years, you got the highest interest rate in that period. Is that computed in the loss?

MR. FRANK: No.

ASSEMBLYMAN PAPAN: Why?

MR. FRANK: Because we are at the mercy of regulators and accountants.

ASSEMBLYMAN PAPAN: So you are saying government is hampering your ability to respond to these market conditions.

MR. FRANK: We have been, I have been particularly asking for four years now, that when you have a loss, on the sale of an asset, you should be able to amortize that loss over the remaining life of the asset had you continued to hold it.

ASSEMBLYMAN PAPAN: Let me ask you the other questions. Is there any effort by any of the savings and loans to end up as tenants in the buildings they own so that we can again capture the money and the cost connected with the buildings that institutions are putting up?

MR. FRANK: Yes, I think that is very general.

ASSEMBLYMAN PAPAN: They are proceeding to do that?

MR. FRANK: Yes.

ASSEMBLYMAN PAPAN: They are beginning to market some of their offices and taking back leases?

MR. FRANK: Yes. I can think of one large institution here in the Bay Area that has sold something on the order of ten or twelve million dollars of headquarters buildings, if you will, this calendar year.

ASSEMBLYMAN MCALISTER: How big a portion of the problem is that, Lou?

ASSEMBLYMAN PAPAN: I imagine they have billions tied up in real property that they are using in the course of business.

MR. FRANK: It's a trade-off of course. When you sell a building, you have to rent it back. And then you pay more, but then you free up your funds. It really is not helpful in the overall scheme of things.

ASSEMBLYMAN PAPAN: Well, in some instances, the price that you paid for the construction of those buildings, you are going to make a profit on it?

MR. FRANK: Right.

ASSEMBLYMAN PAPAN: Okay, let me ask you this. Your REOs as affecting citizens, and that's a matter of public record, has that seen an increase, and to what extent would you say for yourself and in the industry.

MR. FRANK: Yes, the problem of bad assets is -- I don't want to overstate it too much, but it is basically zero. We have not completed a foreclosure on any type of property in four years and as I look at my competitors, I think that by and large that that will hold true for them, too. That is not a factor. The only factor that we have is that we have billions of dollars of low yielding mortgages and we have thousands of savers who want, need, deserve and demand the highest rate on their savings.

ASSEMBLYMAN PAPAN: Another thing, as an academic question, how do you feel about imposing over a definite period of time, some level that we once had -- say we had laws of usury saying that it was in excess of ten. Do you have a figure in mind and would you on that principle -- if everybody had to live on that, what would your sentiments be?

MR. FRANK: A well-run savings and loan, or indeed bank for that matter would like to make at the end of the year one percent more on its funds than the funds cost us. That's our measure of success. If we can make one percent on assets that's doing very well. Very few institutions and hardly any banks and relatively very few savings and loans did that last year. So we have to charge, overall, one point, plus expenses more than the money cost us, if you can stop the money costing us more, I'm all for that. But if you try to put usury on one side of the balance sheet and say to the saver, "Well if this institution won't pay you the highest rate, then call up Merrill Lynch," then it won't work.

ASSEMBLYMAN PAPAN: Let me ask you, sir. Lending institutions whether they be banks or savings and loans, enjoyed in law, a limit as to what you could pay depositors. Did that come about as a result of a kind of power that they wielded at one time?

MR. FRANK: That's very difficult to say. I think that helped, but I also think that there is a perception which a lot of people still hold that indiscriminate competition for funds is what led to the problems of the late 1920's and early 1930's. You have to take your choice.

ASSEMBLYMAN PAPAN: Sir, is there an effort by the savings and loan industry that you know of, as well as the banks, in this state and country, to try to get a handle on something that's gotten loose, that conceivably is going to jeopardize the lending institutions, depositors' money, and cause the kind of crisis that we have with respect to the ability to borrow in your respective communities.

MR. FRANK: Well, the banks are clearly thirsting for an environment in which they can pay as much for money as they have to. Eighty to ninety percent of bank's loans now are variable. In effect a prime rate loan is a variable loan, so banks are wildly enthusiastic about taking off all interest rate limits. Savings and loans which traditionally lent on fixed rate long-term assets say that we need some help, so there's a real dichotomy, but that horse is out of the barn.

ASSEMBLYMAN PAPAN: Does your savings and loan sell U.S. bonds?

MR. FRANK: Yes.

ASSEMBLYMAN PAPAN: Is there a built-in interest on those U.S. bonds?

MR. FRANK: U.S. Savings Bond?

ASSEMBLYMAN PAPAN: Right.

MR. FRANK: Yes.

ASSEMBLYMAN PAPAN: Would you consider them the worst investment going?

MR. FRANK: They are certainly not the best.

ASSEMBLYMAN PAPAN: Let me ask you, is there a penalty if you try to cash those in prior to six months?

MR. FRANK: I imagine so. A person certainly would be ill advised to buy one if you wanted to cash it in early.

ASSEMBLYMAN PAPAN: You must be awfully frustrated knowing that on the one hand government is trying to do all it can for you, and on the other hand, the same government, ours, is trying to really slip it to the people that are buying U.S. bonds.

ASSEMBLYMAN PAPAN: It's a gross inconsistency, it's something we shouldn't tolerate.

MR. FRANK: There are a lot of inconsistencies. The biggest inconsistency I see, and I even see here in the committee if you don't mind my saying so, a lack of understanding of the amount that the borrower pays with what the saver earns. They are inextricably linked and there's no way of getting around linkage. We can only pay to our saver over the long haul what the borrower is willing to pay, and if the saver knows, as he knows right now, that the shorter you stay the more money you make, that affects the coloration of our business.

ASSEMBLYMAN PAPAN: You were locked into long term turnover for the most part five to seven years?

MR. FRANK: Well, we wish they were five to seven years.

ASSEMBLYMAN PAPAN: Are you afraid that your industry is going to be absorbed now that there have been some new federal regulations that I haven't had a chance to examine. Within the next four years is it not possible that many of the savings and loans that we have will be absorbed by these large banking institutions for survival?

MR. FRANK: You see, what I think is one of two things will happen, and both of them will be bad from the point of view of what this committee is looking into. Either we'll be absorbed by large commercial banks or we'll become large commercial banks, one or the other. We're being told unequivocally by this administration, we want you to be banks. Indeed, our regulator, as the Journal said this morning, "I want my members to be banks." Whether or not we're absorbed is a matter only, I suppose, of concern to us and our stockholders, but from a public policy point of view we will no longer have an institution that's confined to making mortgage loans. I make speeches to builders and I use to make them to realtors before Mr. Gillies and I tangled.

ASSEMBLYMAN PAPAN: You're not alone.

MR. FRANK: Thank you, and I always say two things. We make mortgage loans for two reasons: one, because it's the right, decent, the human, the American thing to do, and two, because we're not permitted to make any other loans (Laughter). There are many times in the financial cycle when it isn't economic sense to make mortgage loans. Every Western country has a lender that's confined to making mortgage loans. This country, this year, is going to eliminate that. I think it's a great error, and it's a particularly great error for those people who have short-term seconds, thirds and fourths that they're blithely thinking that they're going to refinance, because they're not.

ASSEMBLYMAN COSTA: What do you think on that point, Mr. Frank, is going to happen in terms of the same question that I put to Mr. Elbrecht? In '79 when the market got tight and the sort of arrangements of creative financing that we've been discussing began taking place with the two and three year balloon date, those loans that were issued in '79 and '80 are now coming due in '81, late '81, '82 and '83. What's the posture of our institution going to be when those people come up and try to get those loans refinanced?

MR. FRANK: Well, it'll be either one of two things. Either we'll say that we don't have the funds, if that's the case, or we'll say it's going to be expensive because savings are expensive.

ASSEMBLYMAN COSTA: How expensive?

MR. FRANK: Well, today savings and loans are authorized to offer two and a half year saving accounts at the compounded rate of 17.4 percent. That's what we pay the saver today. And we'd like to be able to pay the electric light bill, etc., so you have to add something on to that, and when you add something on to that it gets to be such a high interest rate that...

ASSEMBLYMAN COSTA: What are you talking about, guesstimation? Twenty percent?

MR. FRANK: Nineteen to 20 percent which is monstrous.

ASSEMBLYMAN COSTA: That would be the cost of refinancing, in effect, the creation of a new loan?

MR. FRANK: If these rates stay the way they are. Points don't seem to be a big factor in the state. Most institutions charge what it costs them which is a point to a point and a half.

ASSEMBLYMAN COSTA: Let me ask you one other question, and I'll let you -- I know you're probably familiar with it -- a program that Fanny Mae is currently undertaking, which in effect allows them a chance to upgrade their portfolios by wrapping around the old existing loans with a new one to blend in the two rates between the old and the new...

MR. FRANK: Right.

ASSEMBLYMAN COSTA: ...on a gradual basis. Do you think that's applicable in this situation or would provide any relief?

MR. FRANK: Yes I do. I think a blended rate or melded rate would make a lot of sense, particularly if the entire mortgage was written on a new instrument, which goes without saying. Yes I do.

ASSEMBLYMAN COSTA: And with that new instrument, would you -- the Department of Consumer Affairs indicated that we should eliminate the Wellenkamp decision prospectively, in other words, for the future. And this sort of blended rate...if we establish that provision in California, allow that to occur on those new loans...

MR. FRANK: I think it would probably be the best solution for all concerned. It wouldn't be a very happy solution for anybody concerned but it probably would be the best one. We would make less on our money than we could if we lent at a market rate and the borrower might be temporarily better served by keeping the old first mortgage. But I think, really, we have an obligation -- we've got hundreds of thousands, if not in the low millions of people who have balloons coming up, and we've got to figure out a way to serve those people. We're part of this community.

ASSEMBLYMAN COSTA: Do you think a blended rate offers that opportunity to refinance those loans and would give a new loan, as well, at the same time.

MR. FRANK: I understand.

ASSEMBLYMAN COSTA: That's ending the -- or hopefully ending the situation that we're currently in.

MR. FRANK: I think it would defuse that ticking time bomb that I'm talking about. It's not the happiest of solutions but it's better than what we have now.

ASSEMBLYMAN MCALISTER: What kind of blending? I mean what kind of format blending are you talking about, halfway in between?

ASSEMBLYMAN COSTA: Well, what the Fanny Mae program is, is 80 percent of buy down on the first deed, first trust and combines the current interest rates with the old existing loan.

ASSEMBLYMAN MCALISTER: How do you determine what is the stopping point in between, midway, two-thirds?

MR. FRANK: They have schedules.

ASSEMBLYMAN COSTA: Fanny Mae has a schedule that they indicate...

ASSEMBLYMAN MCALISTER: If your old loan is eight percent and the new rate is 16 percent, is that too simplistic to ask what would the rates be.

MR. FRANK: That's right. No, that's right.

ASSEMBLYMAN MCALISTER: What would the rate be?

MR. FRANK: Well, Great Western Savings is in a program such as that right now. I guess the best answer I can give you is what their program is. They're lending at 12 1/2.

ASSEMBLYMAN MCALISTER: You mean if the old rate was eight and the new is 16, they go to 12 1/2?

MR. FRANK: That's right, they're just saying to a group of loans which I think average less than 10, that whatever you refinance will beat 12 1/2.

ASSEMBLYMAN ROBINSON: And the 12 1/2 is a variable?

MR. FRANK: Yes, then it'll be variable.

ASSEMBLYMAN ROBINSON: So you'll take your fixed rate, eight percent loan convert to a 12 1/2 variable rate.

MR. FRANK: That's right! That's part of the consideration for the lender is to change the form of the note. As I say it's not a very happy situation.

ASSEMBLYMAN STIRLING: Mr. Frank, do you agree that there's a concept known as reindustrialization going on, and it's been a conscious national policy to divert money into cost plus loans?

MR. FRANK: I absolutely do!

ASSEMBLYMAN STIRLING: So it's a conscious policy.

MR. FRANK: Absolutely! There is nothing but dry eyes in Washington at the lack of hammers hitting nails.

ASSEMBLYMAN STIRLING: What percentage of the total monthly borrowing that's going on in the total economy, what percent of the borrowing is being done by the Feds or the Federal Government, half, a quarter?

MR. FRANK: Well, let's think for a minute -- the corporate calendar is about $25 billion, the federal government is running a deficit of $60 odd billion.

ASSEMBLYMAN STIRLING: You're talking per year or per month?

MR. FRANK: Per year was your question.

ASSEMBLYMAN STIRLING: Twenty-five billion dollars for commercial?

MR. FRANK: For a corporate, right!

ASSEMBLYMAN STIRLING: Sixty billion dollars for the Feds?

MR. FRANK: Yes.

ASSEMBLYMAN STIRLING: The Feds are borrowing two-thirds of the capital available...

MR. FRANK: Of that. Now mortgages last year were on the order of 100 billion.

ASSEMBLYMAN ROBINSON: Is it $25...excuse me Mr. Frank $25 billion on the corporate calendars? Is that all forms of corporate borrowing, is that everything from banker's acceptances to debentures?

MR. FRANK: No. No, it's in the public markets, corporate bonds in the public market.

ASSEMBLYMAN ROBINSON: So it would be secured...

MR. FRANK: Corporate bonds in the public market, it doesn't count bank loans.

ASSEMBLYMAN ROBINSON: Corporate bonds?

MR. FRANK: Corporate bonds. New corporate bonds.

ASSEMBLYMAN STIRLING: So the total borrowing of the money market funds would go to theoretically to...The Feds, Treasury bills and that sort of thing, are borrowing almost two-thirds of the capital.

MR. FRANK: Now if you just take just those two items, but there are many other sources. I mean you've got state and local governments, and you've got mortgages. You've got banks. The figures are easily available. They're prepared by Henry Kaufman of Salomon Brothers and I'll be happy to send some.

ASSEMBLYMAN STIRLING: What I'm just trying to find out is who is draining down the available mortgage...who's draining down the available lending capacity?

MR. FRANK: Well, let me -- I hate to bring up an extraneous point, I hope it's not extraneous and that is this. You have competition within the mortgage market between people seeking to refinance and people seeking to buy a home. And unfortunately in this country the more money you make, the bigger house you're in, the more Uncle Sam pays towards your housing cost, which is fairly zany, I think. So, if somebody is in a high bracket and they want to refinance, take money out of their home, they can do so more easily than a young couple, because a young couple is only paying 30 percent marginal tax rate whereas the other person is paying 50 to 70 and so they can afford it more. So you have competition even within the pool of mortgage money between people refinancing and people buying a home for the first time, and I'm concerned about the latter. I think we need to do something about that, but not on a state level; it's a federal matter.

ASSEMBLYMAN STIRLING: Just one more thing, sir, from industry's point of view should the balloons start to pop in excess of the amount -- would a moratorium on your foreclosures be supportable by the industry?

MR. FRANK: Well, I don't want you to be misled. The problem of foreclosures for first mortgage lenders is nil because our mortgages are at very low balances and even those mortgages where the person isn't making the payment, the second, thirds and fourths are making the payments for him or her. So we have no problem and don't visualize, can't possibly visualize any problem. I mean, my own institution, we've got 60 thousand loans and they probably have an average balance of 40 to 45 thousand dollars. So you're not going to have any institutional foreclosures on first mortgages at all no matter how many balloons pop. What you're going to have is investors in these seconds, thirds and fourths getting brutalized, and many of them are people that should have never been in them in the first place. And you're going to get homeowners who are going to be dispossessed, but...

ASSEMBLYMAN STIRLING: Since you're not directly affected, then what would you suggest the committee do or what kind of legislation would you think would be appropriate from a consumer protection point of view for both those lenders and those borrowers that are going to be foreclosed on, or could possibly be foreclosed on?

MR. FRANK: I really don't know!

I just wondered if I could just add thirty seconds of some specific statistics which might be helpful to you and that is the cost of the Wellenkamp to us. We have about 15 million assumptions every month. We have about two and a half billion loans and if we didn't have that, we would have additional income somewhere around $20 million a year, and of course it builds up each and every year. If we had $20 million more in income we could pay one percent more on all of our savings, which would be that much more attractive and which would bring in that much more in new savings, which would mean that much more money going out on the mortgage market. And so we hear some of these theoreticians saying and the realtors, I'm sorry to say, saying that short-term Wellenkamp doesn't hurt anybody, but it saps our ability to bring in new money, and it really does cost us a lot of money, and the less money we bring in the more we have to charge for what we have.

ASSEMBLYMAN COSTA: Is there any comparison on that one point in those states that have not had Wellenkamp, because there is only ten that have had a sort of a nullification of a due-on-sale clause?

MR. FRANK: I don't know, Mr. Costa. I don't know of any.

ASSEMBLYMAN COSTA: Mr. McAlister.

ASSEMBLYMAN MCALISTER: What were those figures again on how many assumptions you said you had here?

MR. FRANK: We get about 15 million of loans assumed per month.

ASSEMBLYMAN MCALISTER: Fifteen million dollars worth of loans...

MR. FRANK: So that would be $180 million a year.

ASSEMBLYMAN MCALISTER: That's your company?

MR. FRANK: Just ours, so that would be about six to seven percent of our portfolio every year that instead of being paid off is assumed.

ASSEMBLYMAN MCALISTER: On the point you raised earlier about the possibility of most of your institutions either being absorbed by or becoming banks, isn't that more or less inevitable? I mean with the current economic philosophy that I think is going to prevail for a period of time, with the increased emphasis on deregulation, and the free enterprise system and competition, isn't that almost inevitable, and wouldn't that even be more -- accepting that premise, wouldn't that be to your benefit and everybody else's benefit? I mean banks are diversified. They loan to all kinds of people. You've got all your eggs in one basket in essence.

MR. FRANK: Sir, I don't want to mislead you in anyway. I think it would be excellent for my institution and for me personally and for my stockholders to have a wide open range. I just don't think it's in the interest of public policy to go away from having specialized lenders. Almost two-thirds of all the people in this country own their own homes and they do it because two-thirds of them got loans from savings and loans which weren't permitted to make any other kind of loan. I think from a public policy point of view it's an error, but it is going to happen, and I don't think we can stem the tide. It'll be fine for the institutions. It just won't be very good for the home buyers.

ASSEMBLYMAN MCALISTER: Well at least the loans that would be made, I mean assuming if there still are going to be any home loans, I mean they would be made by...they'd be spread out over a host of financial institutions that didn't have all their eggs in one basket.

MR. FRANK: But sir, just take today. Dupont is buying CONOCO today. They need to borrow seven billion dollars, and they're willing to pay at today's rate at 21 1/2 percent for that money because they think they can leverage it. There is no home buyer that can afford the 21 1/2 percent, so the home buyer is going to be outbid.

ASSEMBLYMAN MCALISTER: But deregulation...we're in the process of deregulation. You're going to have to pay more money to get your money and I mean you're not...I don't think we can go back to where we were five years ago.

MR. FRANK: I agree totally. We cannot, and it won't happen under this administration. We will be totally deregulated, and it'll be fine for the institutions. It'll just be horrible for homebuilders and realtors and homeowners.

CHAIRMAN BOSCO: Mr. Frank, you were going along quite well on formal testimony. It isn't written, but do you have further testimony?

MR. FRANK: No sir.

ASSEMBLYMAN ROBINSON: Mr. Chairman, I have a question.

CHAIRMAN BOSCO: I know that. Mr. Robinson. No, I mean this is very fast, and I just wanted to be sure you got out what you wanted to.

MR. FRANK: You're very kind, and I've been here longer than I should have.

ASSEMBLYMAN ROBINSON: I want to go back to Mr. Stirling's line of questioning that went to who was borrowing? I think that ignores a major factor in this situation, and that's where are the funds going. What effect would you say or do you know that money market funds have had on the institutions in California, probably both banking and savings and loans? You're competing, are you not, with those other types of innovative checking accounts for your deposits, and your deposits translate into housing?

MR. FRANK: It's pretty hard to do it for California but it's easy to see what the institutional flow of funds are. Take a bank. A bank is losing it's low cost savings and buying them back at the highest cost. In other words, they sell CD's to the money market funds, so they're just disintermediating themselves. But that's not true for savings and loans by and large. They don't sell CD's to money market funds, and so their experiencing a change of investment by their savers. The average increase per week of money market funds in the last year to year and a half has been over two billion dollars a week. And money market funds have a variety of investments. In round terms about 40 percent goes into CDs, about 20 percent goes into commercial paper and bankers acceptances, and the remainder goes into a treasury and agency securities of short-term. They have an average maturity of somewhere around 23 days, money market funds.

ASSEMBLYMAN ROBINSON: Their yield, what would you say the average yield of the major money market funds are, Mr. Frank?

MR. FRANK: Well the average money market funds makes about -- charges about half a point, so after costs I guess they'd make about a quarter. But of course...

ASSEMBLYMAN ROBINSON: Then no, that's not what I'm saying. I'm looking at it from the standpoint of the investor, a deposit with you or a passbook account with you as against the attractiveness of 23 days rollover in money market funds.

MR. FRANK: Right. He's getting the advantages of an inverse yeild curve where the shorter the maturity the higher the yield, and he's taking the risk that the yield curve will change and that he won't be able to lock in funds that are a higher rate for a longer period of time. It's a trade-off, and thus far the trade-off has been to the advantage of the person who's stayed short.

ASSEMBLYMAN ROBINSON: But even the large ones, such as Merrill Lynch's, are they not yielding better than 17 percent?

MR. FRANK: Yes, most of them are yielding about 17 1/2 to 17 3/4 percent. As I say a two and a half year account today is yielding on a compounded basis on 17.4, and I think that we'll start to see a substantial inflow into those accounts -- the rates came out yesterday -- from people who think that the Reagan program will work, and that interest rates will come down and so on. In 1975, when the yield curve changed from being inverse to being positive the money market funds lost 40 percent of their funds in a six month period, because they could no longer pay the higher rate. And without any malice I wouldn't mind seeing that happen again.

ASSEMBLYMAN ROBINSON: But would it be fair, and this is my last question, be fair to say that that is a bigger problem in today's housing market and availability of funds in the housing market in California? The competition for the investment is more the problem than the competition for the borrowing.

MR. FRANK: I can't...I'd like to agree with you but I can't. They are inextricably intertwined. Let's just take two years from now when we can all pay anything we want to for almost any savings, and a bank will make a deal with Dupont at 21 1/2 percent and take two points off for expenses and profit and bid 19. And even on the new money, if we lend at 16, 17 or 18 percent and take two points off we'll only be able to bid 14 or 16. There isn't much doubt in may mind which institution will get the most funds and so the two are interconnected.

CHAIRMAN BOSCO: Along those lines, just one quick question. On these Dupont loans, for instance, it seems to me that these corporate take-overs that are happening now probably have an adverse affect on the interest rate. Are those short-term type of loans, though?

MR. FRANK: They vary. They are what they call revolvers or bullets or both, and many of them are for five and seven years, and some are short-term. When you get a line from a bank, that's a variety of indebtedness, some fixed, some variable, some short, some long, some non-prepayable, some prepayable.

CHAIRMAN BOSCO: So that could have a substantial affect on mortgage money availability I would think.

MR. FRANK: Oh, I'm sure of it. I would think that savings and loans would lend us here in California something on the order of $15 to $18 billion, and the Dupont loan alone is half of that.

ASSEMBLYMAN COSTA: What'd you loan last year?

MR. FRANK: I believe around $25 to $28 billion.

CHAIRMAN BOSCO: Are there further questions?

ASSEMBLYMAN COSTA: Just one. Taking off from what Mr. Robinson and Mr. Bosco stated, I'm Chairman of the Housing Committee. Obviously my concern is to try to provide that goal of attainable housing for the citizens of this state. From your comments and from comments I've had with officials of the administration it's extremely clear to me that there is a fundamental change, that housing no longer has the priority in terms of investment capital, and of course it's hard to make the average person understand the necessity of investment capital when you're trying to explain to them how they can get into that house when they need to get into that house. And public awareness and education is difficult at best on these sorts of complex issues. My question to you is since this is really, when the train's going this way, I mean it's real clear to everybody, what do we do in California, particularly, on those things that in the Legislature we have a chance to do -- to try to still provide some investment capital for housing? The creative financing issue aside, how about the new constructions, the stimulation of that building that is necessary? There's some talk about the Callie Mae Program and other investments, but I mean what's your industry see as any salvation or hope besides becoming banks?

MR. FRANK: Well, as I say, I'm the Chairman of the state's Housing Finance Agency, I'm just as vitally concerned as you are. Frankly, all of these suggestions...I just dread saying this. In the light of today's interest rates and today's deregulation climate, we are rearranging the furniture on the deck of the Titanic. We're kidding ourselves. We're gimmicking around with all these things. You cannot provide housing for people when the prime rate is 20 1/2. You just can't. And we can fool around, and we can do a little bit here, and there, but you can't. The other thing that I wish we'd done, I wish we'd had free floating rates on mortgages as they do in England and Canada. If everybody in California paid the same rate on mortgages today, old and new, the mortgage rate would be 12 1/2. But unfortunately we've got people who are living next door to each other, one person's got six and the other's got 18, and the only difference between them, other than that, is that the one paid three times as much for the house as the other. It's really unfair.

CHAIRMAN BOSCO: Mr. Frank, I'm going to get back to the question I asked earlier of the other witness. From what you say there really are no guarantees. The facts all point to the possibility that if more money were made available to banks and savings and loans, they probably wouldn't get into the housing market, at least now.

MR. FRANK: Well, we're seeing the all savers bill which Assemblyman McAlister mentioned does carry with it a requirement to put 75 percent of the net increase into housing. That was something that some of us got the housing industry to tack on as a rider so at least our theory being if you have a tax incentive for savings it should be directed into a specialized purpose.

CHAIRMAN BOSCO: But absent that type of tax incentive?

MR. FRANK: We've got another three and a half years ahead of us of this administration's anti-housing bias.

CHAIRMAN BOSCO: Now let me ask you another question, and I don't want to throw a curve, but I think it's important to this Committee's deliberations. If we did repeal the Wellenkamp decision, I'm positive it would be a benefit to the savings and loans, but would it be a benefit to homeowners and potential homeowners in California? Would the savings that you...or the additional income that you get as a result of that action really show up in the form of more housing, cheaper housing or whatever?

MR. FRANK: I think you have to put strings on it from a public policy point of view. From my own institution's point of view I'd rather not, but I think you have to have strings on it. And I think this melded rate or blended rate that Assemblyman Costa spoke of makes the most sense. It assures that the refinance money will be available, and it will be available at lower than market rate, yet the institution gets a pick up in its income and a change in instrument. I think it makes a lot of sense.

CHAIRMAN BOSCO: But only in exchange for keeping it in the housing.

MR. FRANK: Right, right. Oh yes, I think given a choice right now with this pressure to pay interest rates to savers, an institution given its choice will go to the highest rate investment that it can make. It'll have to.

CHAIRMAN BOSCO: It's interesting because other members of the savings and loans industry, and I don't think they were trying to be dishonest with us by any means, but, in all the testimony that we have had on the Wellenkamp repealer, not only this year, but the last couple of years, it was always put in terms of more money for housing and yet, nowhere did anyone suggest in the industry that what probably is going to happen is that money will go elsewhere.

MR. FRANK: But we are experiencing a rate of change in regulation here that is phenomenal. I am testifying this morning about today's Wall Street Journal, and the Reagan administration this morning came out in favor of deregulation of savings and loans. To give the other witnesses the benefit of the doubt, there have been a lot of changes and nobody ever dreamed these rates would stay up as high as they have, as long as they have.

ASSEMBLYMAN ROBINSON: Well, Mr. Frank, isn't it true that as a condition of your state charter, you are required to have 80 percent of your assets in housing? So if your testimony was offered on the basis of existing state law, it would mean no other place for it to go.

MR. FRANK: I'm not aware of that 80 percent regulation.

ASSEMBLYMAN ROBINSON: It's not regulation, it's a statutory requirement.

MR. FRANK: The Internal Revenue Service charges more taxes when you go below a certain level, but when you are not making any money, that's not much of a threat.

CHAIRMAN BOSCO: Thank you very much.

ASSEMBLYMAN MCALISTER: Would -- if the federal government debt were to decline, say $40 to $50 billion less than it is, is that going to have a major impact on this picture?

MR. FRANK: It is entirely possible, Assemblyman, that what we are reacting to is incredible mismanagement of the financial affairs of this country for the last four years, and it takes more than six months to right it. There are many reputable people that say we are on the right track, and we are going to have stability, and we are going to have a positive yield curve, and just wait and see, and yes, the medicine is bitter but it will cure, and we've all heard these things a hundred times. I think there's a darn good chance that that could happen. I don't know how soon, but I think, I do think we are on the right track.

ASSEMBLYMAN STIRLING: The federal borrowing is still up.

ASSEMBLYMAN ROBINSON: Right, who is going to finance the defense appropriation?

ASSEMBLYMAN STIRLING: In spite of Reagan's valid budget cuts, the fact is that the federal budget is higher this coming next three years than it ever has been in the past and therefore the percentage of the federal borrowing encroachment of the available credit is going to be higher.

MR. FRANK: Plus their interest rate assumptions. For every one percent of interest rate that they are off, it's another $10 billion a year in the debt service, so right now, they are estimating 10 1/2 percent and they are paying an average of 13 1/2 so there is $30 billion that is not in the budget. But things can change and I hope they do. Thank you very much.

CHAIRMAN BOSCO: Thank you very much, Mr. Frank.

We will take one more witness and then have lunch. Mr. Burton Fohrman who is an attorney whose practice is limited to real estate and business matters and is editor of the Real Property News published by the State Bar of California. Thank you, Mr. Fohrman for being here with us.

MR. BURTON FOHRMAN: Thank you very much. Rather than talk theory statistics -- I have none of those, I am only talking real world, practical. My practice is in Riverside and I have been there seventeen years. I think that I have a good feeling for what is going on at the grass roots level. In addition, I have an opportunity as editor of the State Bar realty publication to look at the situation on a larger plane than just Riverside. One of the reasons I believe that I was asked to speak today is that a little over a year ago, I wrote an article about creative financing. In the Summer 1980 issue of the

Real Property News, we had a series of extensive articles dealing with the problems that we are facing today. I admit we didn't handle everything we are talking about. We didn't predict with great accuracy all of the problems that exist today. We dealt in detail with a lot of them. I believe the staff does have a copy of this. I believe they have a copy of the Fall 1980 issue in which we dealt with alternative mortgage instruments.

The reason I wrote the article is that suddenly I had people coming to me talking about this great new thing of creative finance and I was curious as to what the heck they were talking about. And the more I listened and the more I talked to people, I found out there was absolutely nothing new. People were dolling up old devices, standard real estate instrument, in order to provide short-term seller financing. Now before I go into the practical, I would like to get to my conclusion, because I believe, as Mr. Frank does, that we are sitting on a time bomb. If there is no reasonable financing alternatives available in the near future, the bomb is going to go off. Wellenkamp is only the fuse on the bomb. Depending on what you do with Wellenkamp, whether you abrogate it or let it go on, that will determine when the bomb starts to explode. There will, in my opinion, be large scale foreclosures. There will be drops in prices because somebody along the line is going to foreclose. That is the line of lenders, take the properties over and try to market them for what they can to get out of them.

I believe that if you want to look to what you can do for the average person, you better start looking at what went on in the depression era in terms of moratoriums, and other legislation that was enacted to protect the average guy. Now when I talk about creative financing, at this moment, I am only talking about seller financing because I had understood that that was the major thrust of these hearings. There is an entirely different time bomb ticking in regard to the second trust deed, third, fourth, fifth, tenth trust deed market. That time bomb has already begun to go off. That in my opinion is another major real estate scandal. I think it will be much larger than the second trust deed scandals of the '60s. I have a number of people that are working on articles dealing with what the problem is to try and get the information out to people. But that's a whole issue by itself and I would like to -- I'd be happy to deal with it if you want, but I'd like to stick for a moment...

CHAIRMAN BOSCO: That certainly isn't outside the scope of deliberation.

MR. FOHRMAN: Okay, but I would like to stick with the seller financing because I think that's the bigger problem and I think there are a lot more people involved in that. And in order to show you how great the problem is and how many people are involved, I'd like to give one example of one transaction that I am aware of that is going on today. It's representative of the entire scope of the problem. There is a builder that has built some condominiums in Riverside and he has a very high interest rate construction loan. It's ticking away at something like 24 percent. The bank is on his back to sell those condos right now, and the longer he holds out the worse shape he is going to be in. He obviously wants to sell without any conditions, but he can't find buyers who will not impose conditions on their sale, or excuse me on their purchase. He has a 17 percent permanent financing commitment. The buyers are not willing to pay that. So what is the builder doing? In order to move these condos so that he doesn't wind up going broke, he is going to pay the difference of four points. He is offering the purchaser a condo with a 13 percent interest rate, guaranteed for three years. At the end of the three years, it goes to the 17 percent. He's digging into his pocket to absorb the four percent. That is one form of creative financing in today's market. Now the condo that I'm thinking of is selling for $165,000. The people are putting down $35,000. They're getting financing on the first trust deed, and the seller is carrying back a balloon second, due in three years. Couple number one enters the picture. They are a retired couple. They own a small condominium down the hill from these newer, larger condominiums. They bought their condominium ten years ago for $39,000, their first trust deed loan is down to $20,000, the market value today is $165,000. Now they are tired of living in a small condo, they feel that they need to move into a bigger one, so they have placed their condo on the market for $165,000, hoping to get $35,000 as a down payment so they can in turn go buy the new, big condo. When they made their offer to buy the new, big condo, it was contingent on the sale of their existing condo. The builder didn't like it, but he had no choice because he has no other customers. So these people put their little condo on the market at $165,000.

My friend, who is couple number two, is in a situation where their children are grown. They have all left the house. They are sitting in a big house and they're tired of taking care of it, so they want to move into a condo. It just happens in this particular case that their house is worth $165,000. Now they know they need $35,000 to buy the little condo, so they are looking for a $35,000 purchaser. And in order to make their deal work they are going to have to do what couple number one is going to do. They must carry back an all-inclusive trust deed because that's the only way they can provide financing. The financing is not there in the market.

So couple number one is going to carry back an all-inclusive trust deed for the difference between their old $20,000, the $35,000 down payment is all and they will carry it back at 13 percent.

Couple number two, who have the old big house, they purchased their house for $45,000, they have a $25,000 first, they're offering the same deal. They're going to have $35,000 down; they'll carry the difference.

Enter couple number three. Couple number three is coming out to Riverside from Orange County because they are squeezed out of the market in Orange County. They have three little kids and they need the big house. They can't afford it in Orange County, so they are selling their house on some similar type of program. All of these escrows are contingent upon one another. This is real life. I'm talking about a situation that is going on today. I don't know who couple number three is selling to, but somebody in Orange County who's stepping up, maybe they're the first time home buyer. But you can see what is happening, we are creating a domino effect. All of these escrows are contingent upon each other, they are all going to close. They all provide for sellers to carry back financing with a three year balloon. What's going to happen at the end of three years, I don't know. Everybody is banking on the fact that there will be financing available and they can all refinance. But at the end of three years, if it's not there, we are going to have a ripple effect all the way down the line. What we have is the number one domino. In my case, I haven't gone beyond Orange County.

If they default, couple number two defaults, couple number one defaults and we have a whole series of potential foreclosures.

Now this time bomb is already ticking away. This one is just going to begin. It's going to go on for three years. We don't know what will happen.

ASSEMBLYMAN MCALISTER: Can I interject here. Of course, there is nothing written down in heaven that says that everything must -- that there must be a savings and loan to come in and make that loan at the end of three years. I mean that if all the sellers are willing to simply continue to carry the paper, it can go on. In fact, it's probably in their interest to do that rather than to start foreclosing, isn't it?

MR. FOHRMAN: That's right. That is one of the possibilities. In fact that leads to -- earlier there was a question as to why aren't there a lot of foreclosures. There are not a lot of foreclosures for a variety of reasons. One of them is that people are trying to work it out. There are enough people that are caught in the bind, that are accommodating each other, as long as they have somebody above them that will accommodate them.

Another thing that's happening, however, is that some of these people are going out and in order to meet their obligation they are borrowing money for another year. Earlier there was some humor about a two year time limit or three year time limit. Well these people are going out today and borrowing money at 24 percent and paying 15 points to buy one more year's life. That's why your not seeing some of those foreclosures. Another reason is that some of those people who are on the other side, not seller financing, but purchased a third, fourth, or fifth in order to save themselves are coming in and making the payments and preventing the foreclosure.

ASSEMBLYMAN ROBINSON: The situation you described though, there is no real incentive for that builder, if you assume in three years the builder has sold out his condos and he has released himself from his take-out financing, there is no real reason for him to not foreclose and...

MR. FOHRMAN: That's right. And that may set the ripple out...

ASSEMBLYMAN ROBINSON: You have an emotional vender in there. You don't have everyone really in the same position. That builder might very well need that money for his next project.

MR. FOHRMAN: That's right, or he might need it to square away with the bank, 'cause the bank may have advanced him money based upon those three year pay-offs and he has nowhere to go.

ASSEMBLYMAN ROBINSON: That's where the ripple starts as well as stops.

MR. FOHRMAN: That's right, and everybody down the line is then faced with the awful prospect of, which house do I protect, do I protect the house that I'm in or do I protect the old house where I had a lot of equity. Do I begin my own foreclosure and go back to my own house or do I try and do something to work out of the problem. Now that's going to be the emotional crisis that each of these people will have to face. In my particular situation, they all have such big equities that my guess is that they are going to have to go back and try and protect their old equities on the old houses.

ASSEMBLYMAN COSTA: Do you have any idea how wide-spread you think these sort of circumstances are?

MR. FOHRMAN: I think that we are talking about millions of people that are involved in this.

CHAIRMAN BOSCO: In California?

MR. FOHRMAN: In California. Maybe millions is too great. Let me just...I said I didn't have some statistics, I have one. I talked to an attorney who represents a number of escrow associations and he attended a meeting of escrow officers and he talked with them about how many sales, how many closings they had had in the preceding week, as a group they had 150 closings. Do you know how many there were creatively financed by the means of all-inclusive trust deeds. All 150. All of them. So I think that the point I'm trying to make is that everybody who has been selling a house in recent years, in some fashion, is caught up in the problem; the seller, the buyer and the borrower. We have to keep that in mind because what has happened is that we have a lot of people out there advising people to go into these quote "creatively financed deals" who don't understand the risks inherent in them, and there are many, many risks connected with it. I'll try to deal with a couple of them in a moment.

The buyer, if you were in the buyer shoes, you have the advantage that it's a purchase-money obligation and you are protected by the anti-deficiency legislation. The seller is not necessarily protected, and we have situations where we have layers now of these all-inclusive trust deeds. I had somebody come to me recently who wished to purchase a home and the title situation was there was an original first trust deed. In the days before Wellenkamp, the people tried to avoid the due on sale clause, so they entered into an installment sale contract, a real estate installment sale contract. That's level number one. Then when that person sold, they took back an all-inclusive trust deed. The property had been resold four times. We have three layers of all-inclusive trust deeds on top of one real estate installment sale contract. I have no idea who is really in control in terms of the title. Everybody is at risk. It's like a chain letter. The last guy on the totem pole pays the guy ahead of him, who promises to pay the person ahead of him, who promises to pay the person ahead of him, who promises to pay the original lender. And they are all at risk. And the reason they are at risk, is that lots of these all-inclusive trust deeds don't correspond in terms to the things that are ahead of them; some have three year due dates; some have five year due dates. It's a whole mish-mash. And when they come due, let's say in this example where we have a three year wrap around and there is a five year behind it, the guy on the five year is making his payments on a regular monthly basis, the man below him suddenly has a balloon payment on the obligation that he is to pay. The fellow who is owning the property now is making his regular monthly payments to pay them off. The fellow who has the three year balloon says, "I can't, and even if I could I don't own the property. I can't go out and negotiate the loan because I'm not the owner of it." The guy on the end says, "I don't want to hear about that. I've made my regular monthly payments and in this contract it says your going to pay whatever's ahead of me. Pay them off." Well, he can't. Now what happens? What happens is somewhere along the line a foreclosure is going to begin, the buyer on the tail end is protected by the anti-deficiency legislation. No matter what happens he is home free, but the seller who relied upon whoever it was that told him to go into the all-inclusive trust deed situation, he has no protection, he is totally liable on that contract to his buyer. If he can't perform and the buyer loses his home, he's going to sue the seller.

The seller is going around and says, "Who do I sue?" He's going to go to an attorney and the attorney is going to tell him, "You sue the broker because the broker did not properly advise you, did not warn you of the risks."

In the article that I wrote, I predicted that the greatest thing that was going to come out of creative financing, was creative litigation, and that's exact...This is going to be a relief act for attorneys. I think that personally we've got to get out of Wellenkamp, but we can't cut it off right now. I think the blended rate may be the answer. We have to get these people out of the cycle. There are a host of problems that have to be dealt with. Wellenkamp is only one part of it.

We have to deal with the problems of all these all-inclusive trust deeds, and what happens with the terms that don't track each other.

There is even a problem if the terms do track each other. Let me point that out. Where you have an old first trust deed loan at \$25,000 at six percent interest, and the seller carries back a new all-inclusive trust deed that wraps around it for \$75,000 at 13 percent interest in most cases it will provide for, let's say, 20 year amortization, or some other figure, all due and payable in three years. What is happening is that the amortization level on the \$75,000, very little principal is being paid on that. Where you have the old \$25,000 loan at six percent, it's an old loan. A lot of principal is being paid on it. Where we originally started out with a 25/75 gap or \$50,000, that gap is widening. Nobody can tell me who's getting the benefit of that principal reduction. Is it the new seller/lender creative financer that is going to reap the benefit, or is it the fellow that is actually making the payments on the all-inclusive trust deed. It hasn't been dealt with.

In terms of legislation, I tried to think about the things you could do to try and work at handling some of the very practical problems that are out there. One of them is there are still a lot of installment land sale contracts out there, there is nothing that you can do about those, but for the last 15 years every article, every author of every book that has dealt with that particular problem has pointed out that they are a terrible risk, and if nothing else I would like a committee to take a look at that problem and eliminate them, wipe them out once and for all.

CHAIRMAN BOSCO: These are contracts under which the buyer does not receive title...

MR. FOHRMAN: Does not receive title. It began with Tucker vs Lassen. I thought they were dead for a long period of time, and when the Supreme Court had the Tucker vs. Lassen case that gave the opportunity of avoiding due on sale on land sale contracts, suddenly they sprang back. They are still out there. People are still using them. The reasons don't exist to use them anymore, but there is a tremendous danger, and let me point out why. The seller has title, the buyer does not. Many of these are not recorded. What happens if the seller dies, if there's a tax lien against the seller, a judgment lien against the seller, the seller goes into bankruptcy? There's a whole host of problems for that particular buyer, and there's no good way to protect against it. Even if the buyer is successful, brings a law suit and is sustained, he is wiped out, because we are talking about people with average homes. Whatever happens to the seller's title, as a practical matter, the buyer is seriously damaged.

ASSEMBLYMAN MCALISTER: If the contract is recorded though, those problems don't exist, do they?

MR. FOHRMAN: Well, maybe. Legal title still remains. It creates a problem. It's an impediment. It's an outmoded, outworn device that doesn't need to be. And it should have been wiped out long ago. In the '60's there was some legislation that dealt with it. It didn't go far enough, and I personally would like to see it cleaned up once and for all.

ASSEMBLYMAN COSTA: It doesn't need to exist because of the Wellenkamp decision then. It would be obsolete.

MR. FOHRMAN: That's right.

ASSEMBLYMAN COSTA: If Wellenkamp were wiped out, of course... I guess if we wanted to fully address the problem, we'd either have to decide to permit contracts of sale or to wipe them out along with Wellenkamp. Didn't the bill we were considering wipe out Tucker vs. Lassen as well as?

MR. FOHRMAN: Yes.

ASSEMBLYMAN COSTA: You mean that if you wipe out Tucker vs. Lassen, you have to wipe out the land sale contract along with it, because if you wipe out Wellenkamp and you don't deal with land sale contracts, they'll be back full blown. There are a lot of other technical problems dealing with them. They're just as bad from the seller's viewpoint as they are from the buyer's. The only point I'm making is that we have a lot of unsophisticated buyers and sellers who are being advised by people who have no concept of the risk inherent in some of these devices. We have the blind leading the blind, and we need to try to get that cleaned up.

Another thing is that on the all-inclusive trust deeds, there are a whole host of problems that need to be dealt with, and one of the reasons I'm zeroing in on all-inclusives, is that they, in my opinion, are the most prevalent from of seller financing today. I think that there can be legislation covering what happens under differing amortizations. If the all-inclusive amortizes faster or slower than the underlying, that has to be dealt with. What happens, and I think it is a real big problem, if the seller doesn't follow through on his commitment to make the payments? In land sale contracts there is legislation dealing with what you can and can't do with the money. There's nothing on all-inclusive trust deeds. I think that there are situations where the money is not being properly applied. The sellers are in a pinch themselves. They start using the money. The buyers may not find out about it until the foreclosure begins. I think that needs to be addressed. Frankly, I think there are two ways of doing it. One, you allow the seller to keep collecting and post criminal penalties in the event that the funds are misapplied, treating them as trust funds. The other possibility is that you require all-inclusives to be deposited with some financial institution to do the collecting and then the disbursing of the funds. The reason that it is such a problem, is that many properties today have a series of all-inclusives and we have this chain letter that I described earlier. There's great risk to the ultimate purchaser in this chain of money floating down between people. Again, I refer to this article on the wrap around merry-go-round. It talks about how many problem areas there are and I think there needs to be some legislation warning people, just like this subordination legislation that we have that warns right on the trust deed saying, look folks, this is a dangerous instrument, you'd better really understand it before you do whatever it is, because you are assuming all kinds of responsibilities. I think that there has to be a mandate that the terms must be consistent so that the wrap around at a minimum is meeting the payment obligations underneath and has the same type of penalty clauses, the same type of fire insurance requirements, all those things, because we are not just dealing with payments. Trust deeds have all kinds of provisions varied in that fine print that nobody ever reads, require the owner to do a lot of different things. And the all inclusive has to track that where you could get a default along the way for some reason other than the nonpayment of money.

CHAIRMAN BOSCO: Especially in cases like tax liens which would take priority over other recorded liens.

MR. FOHRMAN: There is a whole host of things, and I'm not trying to repeat what is in the article, just to bring it to your attention.

ASSEMBLYMAN MCALISTER: Do we have a copy of this gentleman's article, do we somewhere?

UNKNOWN VOICE: We have one of them and we will get the other one.

ASSEMBLYMAN ROBINSON: I have a copy of both with my disclosure bill. You can get them tomorrow.

MR. FOHRMAN: In terms of Wellenkamp it's a two-edged sword when I talked about -- it's the fuse on the time bomb. If Wellenkamp is -- if the due on sale clause is enforceable you can stop many real estate sales right now. You can kill the home market. If it's not enforceable then you're going to have these creative financing situations going on and we're just putting off the inevitable.

The situation I talked about earlier where the builder, that was correctly pointed out by Mr. Robinson, where the builder pulls the plug, we're then going to have the series of foreclosures down the line. Now that example dealt with three years from now. I think that a lot of these deals began two years ago and that a lot of them are going to start coming due within the next year. I believe that you have to give serious consideration to some type of moratorium legislation dealing with this. I personally believe that the long range effect of Wellenkamp is that the average person's a lot worse off because it's going to come back and haunt the average person who carried back one of these trust deeds without understanding it at all.

ASSEMBLYMAN ROBINSON: Let me ask a question. This moratorium, doesn't it take one of the few disincentives to this type of financing away? If we enact a moratorium, one of the things that could stop this or at least slow it down is the type of information that's out amongst the general public in the experience of their neighbors. I think you take one of the big checks that are built-in automatically in a free system away the minute you enact a moratorium.

MR. FOHRMAN: I agree with you. The problem is that you have hundreds of thousands of people that have no idea what they are doing. They didn't understand that and they're going to be led to slaughter in this situation.

ASSEMBLYMAN ROBINSON: They didn't understand what they were doing, and in a lot of cases they were represented by licensed realtors in the State of California. What's the...

MR. FOHRMAN: Who did not understand it themselves.

ASSEMBLYMAN ROBINSON: And I understand that. What is the current state of the law on errors and omission litigation affecting realtors?

MR. FOHRMAN: I think we're going to have the biggest flood of litigation against realtors the state has ever seen. I already have realtors who are calling indicating that they have real concern that they're getting ripples from people that say, you didn't tell me this and such and I'm now faced with this situation as the balloon comes due, or the multiple layers of all inclusive trust deeds that didn't correspond in terms. I don't know what the ultimate effect is. I believe that the brokers have a serious problem. There was a recent case of Wyatt vs. Union Mortgage which dealt with the liability of a loan broker for failure to disclose the risks connected with the second trust deed loan. It dealt with a lot of other issues, but in that case the mortgage broker was held liable. I think it's just a very short jump from Wyatt vs. Union Mortgage to imposing the same liability on the average broker for not advising people as to what they were getting into on the all inclusive trust deeds. And I'm not being unduly critical of the brokers. There are many attorneys who have used all inclusive...

ASSEMBLYMAN ROBINSON: Is that involving civil fraud?

MR. FOHRMAN: Yes, there was some fraud involved...

ASSEMBLYMAN ROBINSON: But you are separating the two different issues.

MR. FOHRMAN: Right. Right. I think that it shows the liability aspect of the broker for failure to advise quite apart from fraud, and I think that same thing is going to be transferred over in these situations.

CHAIRMAN BOSCO: Mr. Fohrman do you think that it will be one of your recommendations that we look at legislation to require better training on the part of these people that are out there making these recommendations?

MR. FOHRMAN: There was another recommendation that I had that I think that it's not just a question of telling the Department of Real Estate, "Look folks, you need to have a program dealing with it." I think the DRE (Department of Real Estate) has to outline for whoever is going to present those programs the specific risk areas that have to be dealt with. They all have to be pointed out. As people have begun to deal more and more with all inclusive trust deeds, more and more problems are apparent. I think that there has to be a regular format that must be given and, I believe, there should be required courses for realtors.

ASSEMBLYMAN COSTA: Mr. Fohrman.

MR. FOHRMAN: Yes.

ASSEMBLYMAN COSTA: Would you say that, or would you think it's safe to say that in many of these creative financing arrangements that the brokers are, in effect, acting as fiscal intermediaries or in the place of what conventional lenders used to act, of performing the functions that they did in a situation. Would you say that is...

MR. FOHRMAN: Well, in making these...

ASSEMBLYMAN COSTA: ...these transfers of sale.

MR. FOHRMAN: Yes, I think that they do. They are the ones that are giving the advice. The average buyer and seller has maybe purchased one or two homes in their life and they are looking to these people to tell them what to do. They want to buy this house. They don't know how to do it. So that particular realtor is saying, "Look, there's a keen device called an all-inclusive trust deed, and it's a piece of cake. Three years from now, we all know the money market can't last as it is right now. It's going to break at some point, so sometime in the next three years you go out there and refinance it." A lot of people are buying that. They don't understand what the problem is.

Now, I've already talked about all-inclusives and land sale contracts, but those are only some of the devices that are being used. There are other things that are out there that you don't see as much of but they also come within the realm of creative financing and if you're going to deal with legislation you're going to have to touch on those.

You see leases with options. It is another way of trying to get around the due on sale. There are various types of...well, various types of seller carry backs. No matter what they call them they all basically involve the seller carrying back something. Now many of these, we're talking about the fact that there's nothing creative about creative financing other than the name. I saw an article recently that some hairbrained scheme for creative financing. The interesting thing about that particular device, and I don't remember what it was because it was so hairbrained I didn't pay much attention to it; but somebody wrote a response in the next issue on this article that I read pointing out a 800 year old case in England that dealt with that very concept. There's nothing new, and that's the danger in trying to deal with some legislation that is going to deal across the board with creative financing. You have all the normal methods of real estate finance that have been abused, perhaps, in this situation. And if you do something, you have to be careful.

I want to touch for a moment on the second trust deed problem because I think it's a large iceberg of which we have only seen the beginning of the tip, and the tip is a big one. The tip is the Burton case down in San Bernardino where we have tens of millions of dollars. I have had a series of calls from investors, people who went out and bought what they thought were second trust deeds to discover they were anything but seconds. The typical situation runs like this: Somebody responded to an ad to invest $10,000. They were going to reap this terrific rate of return. They pulled the money out of their savings, and they delivered it to this mortgage loan broker. They suddenly discover when things go bad that they have -- just let me take one example out of 11 that I dealt with in the last two weeks. People invested $10,000 in a second trust deed. They had no idea what they invested in except they knew they had part of a larger second trust deed. What they actually had was a $10,000 interest in a $100,000 trust deed. The property had an existing first of $330,000 and a second of $100,000. That's a total of $430,000 of debt. No payments were made on the second. Property immediately went into foreclosure. After it went into foreclosure the people discovered the property was only worth $335,000.

ASSEMBLYMAN COSTA: They sought out the equity...

MR. FOHRMAN: There was no equity...$5,000 equity and the loan was $95,000 over the total equity. That is not an unusual situation. I've seen a whole series of situations where...

ASSEMBLYMAN MCALISTER: Is this commercial property or what kind?

MR. FOHRMAN: This was commercial property, but I also have another one exactly like it on a fourplex. And the people not only were led to believe that they had a second, they actually wound up having a third, and both the second and the third exceeded the market value of the property.

CHAIRMAN BOSCO: Well, one question that I have is -- I mean this problem has always been inherent in second trust deeds and in fact a number of instruments like them. Is there evidence that the problem is getting worse now?

MR. FOHRMAN: I think the problem is much worse. After Prop. 2 we had a lot of people jump into the market as mortgage loan brokers and there are very little restraints on what these people did or could do. I think there has been tremendous fraud practiced, I think that...

ASSEMBLYMAN COSTA: Like Universal and Atlas Trust.

MR. FOHRMAN: Yes. We're talking about dozens of these companies.

CHAIRMAN BOSCO: I think one thing that we didn't pay enough attention to in this committee when we dealt with Prop. 2 is that in addition to getting rid of usury, it really expanded the number of people that are going to be out there making these types of transactions.

MR. FOHRMAN: Frankly there is nothing they can do about all the fraudulent transactions that have already occurred, but I think the door needs to be closed. I think that you need to take a close look at what requirements you need to impose on people that are going to be doing this. I'm one attorney in one small city. I had 11 phone calls in two weeks and they all are very similar experiences right down the line. We are talking about some people whose life savings are being wiped out in these situations and that's...I've talked to some of the attorney's that are involved in the Burton case. It's true that many of those people are retired people who are looking for long-term...(inaudible)...inflation taking all the money out of the savings and loans and sticking it into Mickey Mouse trust deeds. And they are going to be wiped out.

ASSEMBLYMAN COSTA: There is a strike force, I believe, that the Business and Transportation...

MR. FOHRMAN: Governor's staff...

ASSEMBLYMAN COSTA: ...looking into these abuses.

MR. FOHRMAN: Yes there is. And there's also a Governor's Task Force that is considering what should be required of mortgage loan brokers. But since the question was asked about second trust deeds, I want to bring that to your attention, focus a little bit on it.

ASSEMBLYMAN COSTA: Mr. McAlister has a question.

MR. FOHRMAN: Yes sir.

ASSEMBLYMAN MCALISTER: Going back to your statement that the seller in these transactions could end up with liability. I'm not quite sure that I fully followed that. What is the liability that the seller could end up having?

MR. FOHRMAN: In my example, the seller has -- when he bought his property he had an all-inclusive trust deed that had a three year balloon. He goes to sell it, and he finds that he can't sell on anything other than a four or five year balloon. So he goes and carries back an all-inclusive trust deed that has a five year balloon. His buyer is making his regular monthly payments, and then the underlying loan comes due in three years. The buyer says, "Pay it off." Seller says, "I can't pay it off, and even if

I wanted to, I don't have title to the property. I can't go out and negotiate the financing." The buyer says, "I'm not going to pay a penny towards the refinancing. It's all up to you. You pick up all the points," and he can't. We're talking about the average guy that's got a small house. He cannot do it. So now he winds up getting sued by his buyer because the buyer is put at risk. He's going to either have to go out and get the financing, bear the cost of it or he isn't able to get the financing, and he gets foreclosed out.

ASSEMBLYMAN MCALISTER: So the seller is liable because this previous trust deed becomes due, and the buyer who wasn't anticipating this, conceivably might have discovered it had he checked the records, but he presumably isn't told all this and...

MR. FOHRMAN: We're talking about unsophisticated people who do not check the records. They don't even...when they get that title policy they don't even understand what that title policy does.

ASSEMBLYMAN MCALISTER: They don't have lawyers advising them and in a good many cases now I guess now -- there -- well in some cases you wouldn't have a realtor involved. You may just have private parties.

MR. FOHRMAN: Sometimes, sometimes.

CHAIRMAN BOSCO: Well, unless you read A through X in the title policy exemptions you wouldn't know what the title policy does, and I don't think anybody does.

MR. FOHRMAN: Well, it might not even show there. First of all the title company is not aware of the provisions of the promissory note. And the provisions we're talking about only show up in the promissory note. There are very few buyers who are sophisticated enough to request copies of the prior notes. They may look at a title report that talks about the trust deeds but they have no idea...

ASSEMBLYMAN COSTA: Or don't understand what it says.

MR. FOHRMAN: It's not recorded. The note is not recorded so they have no idea what is ahead of them. They don't even know what to ask for. And so at some point suddenly a plug gets pulled and the first thing that they know -- the first indication they have is they get a letter indicating there is a foreclosure coming.

ASSEMBLYMAN COSTA: This is so difficult to deal with because you know I think that the contracts in many of these arrangements kind of rank with the car owner's manuals as being some of the least real documents in the world. And so I don't know how you really offer that protection. You talk about the proper disclosure and a contract. But even if you include that proper disclosure, we legislate it, and force it through. Dick talked about it earlier in terms of the moratorium of foreclosures, and not letting people feel the cause and effect relationship as being important.

I know it's important because I had the lack of maybe political astuteness to get involved in this issue earlier this year. People are extremely unsophisticated on these matters. You try to work with all the various participants, and the fact of the matter is, I hate to use the term, but there are no dead bodies yet. I think it's becoming that way and I believe it will increase next year and it's a phraseology that we use in the political arena, but there aren't the dead bodies, the foreclosures, yet to the degree that people feel that this is a problem, that, hey, I'd better watch out. You know, the warning signals aren't there yet. There haven't been failures or mergers of savings and loans statewide, and so the average person doesn't foresee this as a problem. They have to move, their jobs are transferred, or they want to get into a better home. They're saying, "Hey Legislature, you're not doing anything to give me low interest rates and this is my only avenue to get into this home, because I have to move, or my job's been transferred, or we want to sell our large home and move into a different location, or whatever. So the fact of the matter is Dick's point about the dead bodies and the moratorium is extremely important.

Any changes that we make in this area or that you discussed or offered as options, which all seem to make sense, seem to be areas that we're going to have to deal with. Any changes we are going to make are going to require making these changes palatable in the political arena. And I'm talking about all the interested players in the arena. I'm talking about the players being not only the lending institutions, but the realtors which are an extremely large force within this stage, and the builders, subsidized housing groups, the whole potpourri of the players of the housing chain. Unless you create that awareness and that sensitivity, and unless maybe we have some dead bodies, and the people actually say, "Hey, this is terrible," then we're not going to see the changes that you outlined or some of the other changes in this area.

MR. FOHRMAN: If I could stick with your dead body analogy for a moment, I think the real policy question is are you going to build a big morgue or are you going to give these poor unsuspecting people some first aid before they get slaughtered. We are talking about people who have no idea of what they are facing. They were led down the primrose path, and is it fair to those folks?

CHAIRMAN BOSCO: I want to thank you for abandoning your private practice today to be with us. I think that was above and beyond the call of duty. And I think if you would be willing, we would like to talk with you more about legislation. And although it's lunch time now I'm sure everyone will want to return for Mr. Gillies response later this afternoon. It should be very interesting. We will return at 2:15 this afternoon.

MR. SAMSON: What I want to talk about is the manner in which an unscrupulous person, and I'm going to focus on the real estate broker, the licensee, that has come to my attention that is engaging in this unscrupulous scheme using creative financing techniques. I have prepared a written statement, and I have handed it out to the members of the committee because it contains certain exhibits, and even though I'll be talking without referring to my statement verbatim I will have to refer to the exhibits to make my testimony somewhat clear. I have, by the way, eight years of experience with real estate crimes both civil and criminal. I receive a lot of publicity from that activity, so I get a lot of phone calls. Like Mr. Fohrman was saying, he averages 11 a week. I average three or four a day. I also do a lot of public speaking at brokerage houses, multiple listing services, I got Grubb and Ellis coming up in a couple of weeks. I've talked to the Escondido Multiple Listing last Thursday, so my remarks are based upon current information that I received from the industry out there doing it. And my remarks that I am going to make are based on a very small minority of the people in the industry. Overall they really can't see the forest for the trees. They think they are doing good and they're trying their best. But the scheme that I'm going to describe is the unscrupulous person who's taking advantage of the fact that the public is now educated to taking paper. Because they know they have to take back paper, they're accustomed to it.

There's a book out by Mr. Robert G. Allen, Nothing Down. Perhaps you've read about it. It's very persuasive. In fact, there are clubs being formed in San Diego called RAND groups, which stands for Robert Allen Nothing Down investment clubs where they try to implement this theory of getting into property for absolutely nothing down and perhaps a negative price being paid back.

The way the scheme works is that the buyer, when he comes into the transaction, refinances the equity and gives part of that equity back to the seller as his down payment. The points that he has to pay, and right now it's about 16 points, can only be accomplished by increase in the sales price. Now in the standard legitimate transaction, under RAND, you would increase the sales price only by that amount of money, the amount of points you had to pay to get the money for the down payment. The problem that's going to result is that the property will now be over encumbered. You've got some more loans to pay, and if you're speculating for investment purposes, it's doubtful whether or not you can provide enough cash for the negative cash flow that's going to be created. And that seller may have to take the property back that's now been over encumbered. And it's pretty widespread.

What I've done, if you'll look on my statement, attached to it are some exhibits. I've got exhibit 1A and 1B. I point them out because these were submitted by licensed real estate brokers. Both properties were in Vista, a city in north San Diego County. One is typewritten and one is handwritten, but the language is identical. These two brokers are 40 miles apart. So the scheme is pervasive. Now these were brought to my attention just in June, and I'll credit the industry for this. It was a seller's agent that called me and said, "Look what we have here. What do you think?" I was appalled for two reasons. One, it puts the seller at risk and in jeopardy, but it's done by licensees. And that bothers me. You can see right there on the document it says by the state he is a licensed real estate broker. But you have to look at the term.

ASSEMBLYMAN ROBINSON: And that's required by existing law.

MR. SAMSON: Actually there is no regulation or law. I think they do it as a matter of practice so they can't be sued for non-disclosure. I don't think you'll find it written down any place. It's an interesting fact, but I don't think you can. But everybody does it just to avoid the problem of having this thing fall apart in civil litigation, have it come back that it was a failure to disclose the fact that they would quote the expert in this transaction. In the first one that you see here, you will note that there's a $15,000 down payment in (B). The language that's curious here, "buyer to assume subject to," is really funny language because you do one or the other. You'll note that both offers use that same language. But the important thing is (c), that buyer is to obtain a new second trust deed not to exceed 75% of the appraised value. And here is where the problem lies. Because that will go through a mortgage loan broker...I'm going to talk about them. By the way I was listening to Mr. Fohrman -- I don't want to get ahead of myself, but if you want to hear a horror story...I'm personally coordinating the complaints on Universal Financial, and I think the worst is yet to come. It's really a terrible problem that we are facing.

But with this at hand, let's look at this, in fact, in the first, the property is on the market for $99,000, we're going to refinance that for 75 percent or $75,000 from which we'll take the $15,000 down payment, and the mortgage loan broker will of course deduct the existing first encumbrance leaving some cash. Now this is not really going to generate a lot of cash for this particular buyer, but should this transaction unwind that seller's going to have to take back this piece of property with a brand new encumbrance and some new payments that he didn't think he was going to have to come back on.

The rest of it you'll note under paragraphs E and F is a third and fourth trust deed. The third will be some payments back to the seller and the fourth is interest only compounded note payments all due and payable in three years which is going to generate one big balloon -- three years of interest compounded over that period of time!

The second one bothers me though, because if you will note here you have a very low first mortgage. By the way this offer was made, as we've heard throughout this morning, by a very unsophisticated seller, doesn't speak very good English, a Mexican family. The offer is for $78,500 with $20,000 down, buyer to assume "subject to" the existing VA for $9,500 -- and with that low down watch what happens when you refinance the second -- buyer to obtain a new loan and second trust deed, not to exceed 75 percent of the appraised value, $49,000, of which the loan broker would probably exclude $9,000 still leaving $40,000 of which $20,000 only goes to the seller. That buyer now has $20,000 cash in this transaction. Now in this particular one, this particular broker says he does several of these a week, and he expects to use that cash to help maintain the negative cash flow and hope for an equity build-up so that he can sell this property in a couple of years at a profit. A couple of problems if there is no equity build-up, if prices don't continue to go up, he can walk away from this deal and as we've heard he'll probably have 580B purchase money protection, which I want to speak to in a few minutes. And then once again you have the third and fourth trust deeds that are created to over-encumber the property, and the fourth or fifth trust deed, which is interest only with a balloon payment to compound at the end of three years. Now those are technically, strictly legal, no problem deals, but they put the seller at a great deal of risk, and I think that something should be done in this area.

Now let me show you a truly unscrupulous transaction which is presently being litigated.

ASSEMBLYMAN STIRLING: Wait a minute. If you say something should be done, what do you suggest?

MR. SAMSON: In the typical transaction, the buyer never sees the seller's escrow closing statement and vice-versa, the seller never sees the buyer's closing statement. The seller does not know in some cases how much cash is being disbursed to the buyer. I would recommend that in these creative financing schemes, like the ones I'm describing, where a cash or a credit is being disbursed to a buyer, that it be done only with the explicit approval of the seller, that he initial that buyer's closing statement, and further where over-encumbrance is occurring, and this next example I show you is pretty bad, that where the property is being over-encumbered by a new loan that the seller be required to inspect the buyer's financial statement and approve that loan package. In other words, that new finance that is coming down. The seller should be aware that the buyer is paying 16 points and some other costs to get that cash to make the down payment, and take some cash out. He should be alerted to that.

By the way, many of these deals are done through brokers exempt escrow. I'm recommending that the Financial Code Section 17006 (d) be repealed. That you not allow real estate brokers to handle their own escrows. In eight years of prosecution, most of the really bad transactions that I have had to prosecute have been done through a brokers exempt escrow. If brokers want to do their escrows let them incorporate under the Financial Code. Let them operate like any other escrow company. From what I have seen it's very, very difficult for the employee of the broker, the escrow officer working in the same office just a desk apart, to have any independent judgment when it comes time to close that transaction. They're an employee of that broker and that broker is an agent of one of the principals -- borrower, lender, buyer, seller -- and he has a strong inclination to make that deal go through. So my recommendation is that that should be repealed and that if brokers want to operate escrows, let them incorporate and do it like anybody else.

Also, another recommendation would be that Code of Civil Procedure 580(b), which provides purchase money protection, be amended so that it applies only to owner-occupied property. These transactions I'm showing you, these people did not move in or intend to move in. They were buying for investment purposes. I don't believe that 580(b) protection should be afforded to them. I might point out that when you get to creative financing schemes such as these, it's entirely probable that if the matter were litigated that under the 1972 Spangler case, a California Supreme Court case, it's doubtful that 580(b) protection would be afforded, but it would have to be litigated. I think perhaps the statute should explicitly spell out that that type of purchase money protection should be limited to the owner-occupied, single family residence.

On Exhibit 2...

ASSEMBLYMAN MCALISTER: Before we go over there, can I just ask you a question? Maybe I'm just missing something, but I'm trying to add up these various figures on these two purchase contracts. Well, I'm thinking you just take one of them.

MR. SAMSON: Well, they add up to a lot more than the purchase price.

ASSEMBLYMAN MCALISTER: Yeah, they add up to more than the purchase price.

MR. SAMSON: Over-encumbered. So two triggering events, over-encumbering the property from the purchase price and the fact that cash goes to the buyer not the seller. Those are the two triggering events when the proposals I make that independent escrows be used, that purchase money protection be denied, and that the seller approve that explicitly with an examination of the buyer's financial statement. Those are the triggering events where those things should be...

ASSEMBLYMAN MCALISTER: I mean, if the seller looks at this just on the face of it, might it not occur to him that while there's a first that's going to be assumed...that of course is not the seller -- that's presumably the bank -- then there would be a second from somebody else, then he's got a third and a fourth...

MR. SAMSON: Right.

ASSEMBLYMAN MCALISTER: So he might never get paid.

MR. SAMSON: That's exactly right, and if he doesn't get paid and takes his property back he's got a big mortgage that he didn't know about.

CHAIRMAN BOSCO: Why would the buyer or the seller, excuse me, the buyer gets cash from the -- just...

MR. SAMSON: That's the way the transaction works because the seller doesn't understand it. That's why, and that's the whole thing.

CHAIRMAN BOSCO: (Inaudible)...that he does get cash from this transaction...

MR. SAMSON: From the refinance.

CHAIRMAN BOSCO: ...as if he were borrowing it from a bank or something.

MR. SAMSON: The buyer gets it from mortgage loan brokers. I'm going to speak to that issue, private money, equity, hard money lenders.

ASSEMBLYMAN MCALISTER: Of course the only reason those people were loaned money when it exceeds the value of the property, is that they're getting a second, I mean instead of a third or fourth.

MR. SAMSON: The hard money equity lender's security does not exceed the value of the property, it's the paper that goes back to the seller, that exceeds the value of the property. The equity lender is very secure. He can come in and take this property over at a distressed price and be quite happy.

ASSEMBLYMAN MCALISTER: Do you think that the sellers who will do this are ill-informed sellers?

MR. SAMSON: Yes. In these two cases, and I'll give credit to the brokerage industry. It was a seller's agent that called these to my attention. But if five or more of these are occurring a week, there's a lot that I don't know about. Either the seller's agent is not alerting someone or it's a for sale by owner only with no help of a real estate agent.

ASSEMBLYMAN MCALISTER: And then the buyer figures that eventually he's going to get cash out of it which he'll use to maintain the property, and then eventually the property appreciates and so he sells, and everybody is presumably happy, but if it doesn't happen he just kind of walks away from it.

MR. SAMSON: That's right and he may claim purchase money protection, but he may be able to claim that until litigation occurs, and under Spangler he may lose. It's doubtful. That's why I'm talking about 580(b).

But at the close of escrow, this buyer gets the cash for the down payment and maybe some in-pocket too. And the lower the existing first encumbrance, the more cash he getsto walk away with. In the second example, the handwritten one, he gets $20,000 cash, probably $15,000 after he pays his points. But when he closed escrow, he takes $15,000, pays $5,000 to the loan broker, and gives $20,000 to the seller, and he's sitting with $15,000 cash and claiming no personal liability for that transaction. If that seller takes back the property, he may not be able to afford that newly created second.

ASSEMBLYMAN ROBINSON: Okay. On the first example, do you know what the second trust deed was for?

MR. SAMSON: Well, they always go 75 or 85 percent of the appraised value.

ASSEMBLYMAN ROBINSON: Okay, well if you went 75 percent, and I assume that the property must be appraised at... (Inaudible).

MR. SAMSON: At the offering price. This one breaks even.

ASSEMBLYMAN ROBINSON: Well it would be more than that the way I figure it. He's got a first of $53,900. If he gets a 75 percent second, that's $75,000, so that's $125,000 he's got there. Then you get...

MR. SAMSON: No, you subtract out the existing first. The loan broker that makes the loan up to 75 percent would subtract out the existing first and give you a net amount. But this still increases enough cash with the buyer that's buying in. It goes through a loan broker.

ASSEMBLYMAN ROBINSON: So it goes to $75,000 after you get to that line.

MR. SAMSON: Right. They'll give some to the seller for his down payment, give some to the loan broker for his points, and then use whatever's left for whatever purpose.

ASSEMBLYMAN MCALISTER: What you mean in this case, is that they wouldn't loan $75,000. They would loan $75,000, but they would use that to pay off the first?

MR. SAMSON: No, they would leave the first, they would just take that out of the amount. They'd say, "We'll go 75 percent, but we'll cut out any existing first. You take care of that yourself.

ASSEMBLYMAN STIRLING: So, so they would give him then $21,000.

MR. SAMSON: Something on that nature, yes, which provides the down payments and the points and the cost. The buyer then gets in for absolutely no money of his own at risk.

ASSEMBLYMAN ROBINSON: Why does he have two different notes on Items D and E?

MR. SAMSON: Well it increases the price to the seller and makes it more attractive. One he's going to make payments on, one he's not.

ASSEMBLYMAN ROBINSON: Oh I see.

MR. SAMSON: One will gallop along with interest only to be accumulated and compounded and due in three years, and that is a lot of danger, and we've been hearing in terms of balloon payments.

ASSEMBLYMAN ROBINSON: Okay and now you're saying that he's protected under 580(b).

MR. SAMSON: The buyer's protected.

ASSEMBLYMAN ROBINSON: The buyer is.

MR. SAMSON: He will certainly claim it. What I'm saying under the case law he may not be able to, but unless you litigate that, he will certainly walk away from it.

ASSEMBLYMAN ROBINSON: Okay and so the seller forecloses under Item E of his contract and he has to pick up the $75,000...

MR. SAMSON: Well it would be a second trust deed for $21,000, yes.

ASSEMBLYMAN ROBINSON: So not only is he out whatever payments it takes to catch up on the first at the time of foreclosure, but he is also out the $21,000 for the mortgage broker.

MR. SAMSON: Exactly, and if he can't afford to do it, that investor that the loan broker put in there, he'll take over the property, which is what I foresee happening for the average person who doesn't have that kind of cash to feed one of these things.

Let me give another little note that shows...

ASSEMBLYMAN COSTA: How widespread do you think this is in San Diego County?

MR. SAMSON: Well, if they have RAND Clubs, I don't know. I'm just now starting to get these, in the last three or four months.

ASSEMBLYMAN COSTA: I'm sorry, I wasn't here earlier. What do you mean by RAND Clubs?

MR. SAMSON: RAND stands for Robert Allen Nothing Down Investment Clubs.

ASSEMBLYMAN COSTA: Oh, okay.

UNKNOWN VOICE: I think it's something you ought to read, Jim.

ASSEMBLYMAN COSTA: No, I've read it. I went to one of their meetings. It was very interesting.

ASSEMBLYMAN ROBINSON: How much did you buy Jim?

ASSEMBLYMAN COSTA: I was giving a speech on the abuses on creative financing. I was not very popular -- I was in the wrong place.

MR. SAMSON: I think it is relatively widespread because I stopped in to the Department of Real Estate yesterday just to chat and they had five deals from this same broker that I just told you about that had been referred into them from all over the country. So he's running around doing it a lot.

ASSEMBLYMAN COSTA: Do you think this is exclusive only by RAND Clubs or...

MR. SAMSON: No, no I think a lot of people are getting into it. The word is out and people are seeing it and using it and starting to run with it.

ASSEMBLYMAN COSTA: What are the means, investigative means, that you use to determine these sort of abuses in creative financing?

MR. SAMSON: Well as you said earlier this morning, I don't get to it until they are dead bodies. That's the unfortunate -- I'm seeing something at the very front right now that I don't normally see until the foreclosure occurs and then we have to go back and try to figure out who did what to who.

ASSEMBLYMAN COSTA: Do you use the County Assessor's Office?

MR. SAMSON: Yes, we do use -- we use any recorded document. Usually there's a warm body coming into the office and saying, "Look what's happened to me." And then we go back and restructure the deal from whatever escrow records or recorded documents or whatever.

ASSEMBLYMAN COSTA: Some of my friends are telling me that we are really dealing with a few isolated cases, that this really isn't the norm, and that the situation is not as widespread as I sometimes convey, and that maybe I'm really making a mountain out of a molehill. And that's really part of my concern. I'm trying to get a handle on how widespread this is. Your office, the District Attorney's office of San Diego, has been one of the few district attorneys offices statewide that has really taken a lead in this area.

MR. SAMSON: Well as I said earlier, and you have already pointed it out, we don't find out until it is too late. I'm not going to find out how many of these deals have been going on right now until the seller finds out he has been had. That could be three years down stream. It could be a year away.

ASSEMBLYMAN COSTA: But can you make any estimation of how much of a problem you think this may be in San Diego County?

MR. SAMSON: I think it will affect five percent to ten percent of the market.

ASSEMBLYMAN STIRLING: Do you think that the escrow being at arms length from the broker would have a preventive effect on this?

MR. SAMSON: I think so. In my prosecution I have found that the escrow officers who are acting as a dual agency in between two principals take every conceivable precaution to protect themselves and if they see something they don't understand they're very quick to rewrite it or to talk about it or to make sure that the principals understand. Take due on sale clauses. They have a standard little clause they've put in there to make sure you know what you're doing about this and it goes right into the instructions. There is a further problem. When people read, they do know what they are reading. And I don't know how we are ever going to overcome that. The average person just doesn't understand what he reads, and he relies upon someone who tells him what's in there, typically the real estate broker.

ASSEMBLYMAN STIRLING: Mr. Gillies, could you comment on that proposal when you testify?

ASSEMBLYMAN MCALISTER: I think there's been some -- this gentleman said something very significant. You said this problem exists in five percent to ten percent of the sales in San Diego County.

MR. SAMSON: I have no basis for making that opinion. I haven't done any research, except what's coming at me now.

ASSEMBLYMAN ROBINSON: You mean the deals of the kind that we're looking at here in these exhibits.

MR. SAMSON: Yes. I get that feeling, yes.

ASSEMBLYMAN ROBINSON: How could this be researched on any kind of scientific basis so that we could determine the truth in that?

MR. SAMSON: Well you could go through all the closings that have been recorded. That's another problem too that's going on that I'm sure you're aware of, the masked sale where holding escrows are being used and nothing is being recorded. If anything has been recorded you could just contact the principals, contact the seller and get his copy of his escrow instructions and it would be very quick, but some of this staff is not recorded.

ASSEMBLYMAN COSTA: Isn't it very difficult to determine that though really?

MR. SAMSON: Determine what?

ASSEMBLYMAN COSTA: How widespread this is.

MR. SAMSON: It is very difficult.

ASSEMBLYMAN COSTA: I mean, okay for the principals, it's very hard to find the principals.

MR. SAMSON: One thing that I can say is that I know that, like these RAND Clubs, they're very eager. They salivate over this, and so it's picking up.

ASSEMBLYMAN COSTA: I think the RAND Clubs are asking for what they get. I mean if that is the worse example, I guess, of the abuses. I'm more concerned about average people, potential buyers of homes or people who need to sell their homes, average realtors. They are forced into these situations, not necessarily because they think it's, you know, the panacea or the best thing since sliced bread. But because the market's so damn tight and things are so difficult in the housing situation today in not only California, but nationwide, they view this as the last resort, the only means to the end, so to speak. They go forth with this hoping that, you know, housing will continue to appreciate at 11 percent to 14 percent per and betting on that, not the best sort of fiscal prudence that one might normally operate under. They are thinking that this is a way to get by not knowing that, in fact, it is really full of pitfalls and that this sort of contract is not one that the average consumer ought to be involved in. I'm more concerned, I guess, about the widespread level in that area.

MR. SAMSON: Well I think Mr. Fohrman has already talked about that. His remarks this morning addressed that problem, and as I listened to him, he seemed to think it was quite widespread in terms of this domino effect from one person relaying upon another on this creative financing. I've been focusing on what I consider the abuse of the creative financing. Creative financing, as he pointed out, is perfectly legitimate if everybody understands what they are getting into. If you are betting that the equity will be there and prices will rise, well I see nothing wrong in speculation, as long as we all deal at arms length with open honest information.

ASSEMBLYMAN COSTA: Is that occurring today, do you think?

MR. SAMSON: No. It does I think to a limited degree where you have educated real estate agents who go over it carefully with their clients. The problem is that most agents that I talk to, and I think they have good intentions, but they really believe that there is going to be at least a ten percent increase in prices each year, even now. And I don't know if that's the case.

ASSEMBLYMAN COSTA: And you think they are promoting these transfers of sales based upon those assumptions even with the best laid intentions?

MR. SAMSON: Yes. I don't think they have any evil intent. I think they're involved in a situation where -- and being a salesman, they always have a positive attitude in any event. Most of the ones I've talked to, you know, they really think they are doing the best thing possible. They really can't see the problems that are being created; Mr. Fohrman described that. They really can't see these problems. Maybe the appreciation will take place and the problems will not occur. I don't know.

CHAIRMAN BOSCO: Okay, could we go ahead and move on then in terms of...

MR. SAMSON: Let me just talk about Exhibit II because this points out the really unscrupulous transaction that can occur. And by the way, I have more in my brief case, but I figured these would be the easiest to talk about.

You will note this one here. This, by the way, was free and clear property, and the actual offer, I don't want to complicate it more than it was, it was only $85,000 and both sides agreed to pump it up to $97,000 because it would look better on a loan document. But as written here, the offer was for $97,900, a $60,000 first will be created and the seller will take back a $59,000 second right there. You start off with $85,000 sales price, but your closing end is on $119,000 right off the bat, which is a part of the transaction.

Now to really show you how this works, I direct your attention to the closing escrow statement, 2(D), for the seller. At the top it shows that $13,000, which was a wash transaction to raise the price, the important thing is of course the broker gets $5,000 commission, the seller gets $19,000 at the very bottom. That's his cash that the seller got plus his note. If you take a look at the page 2(E), which is the buyer's closing statement that the seller would never see, you find that the loan broker down here under new loan charges, the lender's commission was $7,000 and the buyer in this case walked away with $29,800. Now if I had $30,000 in hand, I don't know if I would stay around to see what would happen. I'd take my profit. And this is occurring. This particular case is subject to litigation and you know there are going to be a lot of people that will be sued in this. I don't know what the end result will be, but here again you've got a year or two of litigation plus a lot of legal expense that's going to be involved. I don't know that the seller would have initialed that disbursement, and if he did maybe he had an incompetent transaction, but what I'm saying is that I would suggest that the seller have to initial that disbursement to his buyer. That the seller explicitly approve that as well as the loan package. What are the terms of this loan package? We don't know whether it's a one or two year transaction, we don't know the rate of interest and the points being paid. But the seller is the one that should approve something like this. I think that is fairly easy to implement.

Okay, finally one other thing, you know, I don't have a lot to say in terms of the mortgage brokering abuse, I got into this early in the year because of Universal Financial, which is probably the worst of all examples, and I included, by the way, Exhibit 3 which is an appraisal that was furnished to an investor in Universal Financial on a commercial piece of property, and what they did was take a residential, single page document, type in the word commercial, and simply plug in a figure. This is so blatantly bad that it doesn't require further comment, and I think that Universal Financial speaks for itself. We've talked enough about that.

Let me show you the next one on Exhibit 4 (A), (B), and

(C) because here's what I'm running into with mortgage brokers. They, by the way, fund the transaction that I described to you. That's where the money comes from. From these overencumbered properties, where the buyer walks away with the cash. Exhibit 4 (A) is a document prepared by a mortgage company with a CIMBA (California Indepedent Mortgage Brokers Association) logo at the top, which would indicate a fairly good company of some standards. And this is a brochure handed to investors which I think if you were to operate your business in this fashion, I would not have anything to say. This is about as good as you can do it. These two pages lay out how it should be done. In the middle of the page it says we use strict underwriting principles including independent fee appraisers. That is not the case. This investor who put in about three loans, this particular one was $6,500, and I just got this last week when the investor came in. He had been reading about things in the paper regarding their documents and was concerned about the bad publicity. The brokerage business asked for the appraisal and was told it was confidential. When pressed it was produced and if you look at 4 (C), it's a year and a half old and it's in-house. It was not a fee appraisal, it was an in-house appraisal. What I would suggest then with loan brokers is independent fee appraisals be required and that independent escrows be required. They're doing their own appraisals and escrows.

Perhaps the Department of Real Estate should think about a special license for loan brokers just as they do for security dealers, that they have a special endorsement and pass a special test. Right now, my perception of much of the loan brokerage that is going on is that it is being done by amateurs, a lot of which is the result of Prop   that allowed them to advertise fantastic rates, and anybody with a real estate brokers license could get into the business. And that's exactly what Mr. Burton in San Bernardino did. He collected a $100,000,000 in one year, and said he had no place to put it and started using it himself, and I think you are going to see more of that.

ASSEMBLYMAN COSTA: You said require a special license for loan brokers, require independent fee appraisers...

MR. SAMSON: And independent escrows.

ASSEMBLYMAN COSTA: ...and independent escrows.

MR. SAMSON: And I think there's a part of that, if you really get into details, I haven't got into any detailed aspect of it, but it might not hurt to have capital requirements for loan brokers, to make some kind of a net worth statement mandatory. I don't care what the figure is, $25,000 or something, but perhaps they should have some basis, some substantial financial basis of their own at stake here. I don't think that's a horrendous requirement.

CHAIRMAN BOSCO: At least posting some type of bond or...

MR. SAMSON: A bond or simply a net worth statement certified by a C.P.A. that they are worth so much money.

ASSEMBLYMAN COSTA: Aren't they required to have some sort of a reserve?

MR. SAMSON: Not a loan broker. Anybody with a real estate license can broker a loan.

ASSEMBLYMAN COSTA: It doesn't have to require some sort of reserve to protect the...

MR. SAMSON: No, nothing. Absolutely nothing.

ASSEMBLYMAN COSTA: Would you advocate that?

MR. SAMSON: Wouldn't hurt. I think there are a lot of ways to go about it including an annual reporting system. For instance the HUD Reports by certain mortgage brokers and bankers that operate as agent for S & L's, or on secondary markets, they file certain statements that I don't think would be a burden to the industry. That if they had to file these with either the Department of Corporations or Real Estate, simply in terms of the number of loans they're servicing and the foreclosures or delinquincy rates, at least then there would be some regulatory agency that would have an early warning sign that maybe something is going wrong with this particular brokerage.

CHAIRMAN BOSCO: Well thank you very much Mr. Samson.

ASSEMBLYMAN COSTA: Excuse me, Mr. Chairman, I missed a point here that you covered prior to the mortgage brokers problems that lie in with that. You said the seller should be required to know certain things prior to financing potential buyers into the...

MR. SAMSON: In the typical, traditional, historical real estate transaction the seller never sees the buyer's statement and the buyer never sees the seller's closing statement. I simply said that whenever there is going to be cash or credit and you have this over encumbrance over the sales price, where the buyer is taking cash out, the seller should approve that disbursement of cash.

ASSEMBLYMAN COSTA: What you're saying, in effect is that the seller ought to at least have some confidence that the buyer be able to meet somewhat the same qualifications that he had to meet when they originally were extended the loan.

MR. SAMSON: Essentially, yes.

ASSEMBLYMAN COSTA: And that is -- is that not part of the problem that we are dealing with today as it relates to the Wellenkamp decision, in that on transfers of these sort of sales when the due on sale clause was in effect the lending institutions could determine whether or not that buyer could meet those qualifications prior to extending the loan, whether or not you bumped it up at a new interest rate. In extending the loan again, they were attempting to insure that the potential buyer meet the same sort of qualification standards that the original person who received the loan did. Is that correct?

MR. SAMSON: I believe that to be true, yes. I think that under the present system borrowers and buyers are not being properly qualified.

ASSEMBLYMAN COSTA: And that is one of the -- therein lies one of the problems under the Wellenkamp decision, and that is the sellers have really no ability to check or determine whether or not those potential buyers or those people who are assuming their loans can meet the same qualification standards that they had to meet.

MR. SAMSON: Yes. But I also see that as part of the second trust deed hard equity market that the loan brokers don't have to qualify on the borrowers either. They're simply looking at the equity in the property. In fact I've talked to some where they didn't even get a financial statement or run a TRW. They simple made the loan. And there was a second trust deed on a new sub-division and the borrower didn't make a single payment. And when I asked the broker, he says, "No, we didn't ask for any financial statement because we looked at the equity in the real estate." And that equity, by the way, was not there.

ASSEMBLYMAN COSTA: Everybody's betting on the appreciation.

MR. SAMSON: That's right.

CHAIRMAN BOSCO: Thank you very much. I appreciate you being here and also your work. Our next witness is Sherman J. Maisel who's an economist and Professor of Business Administration at the University of California Berkeley. Did I pronouse your name correctly?

MR. SHERMAN J. MAISEL: You're correct. Thank you Mr. Chairman. I'll briefly go over my conclusions which agree with others earlier and then give a little economic background so that you can stop me at any time. I know you're rushed for time. One, I think there is a necessity that buyers be protected against their own ignorance, but my experience in trying to draft the regulation under Truth-in-Lending shows that this won't do much good. What you really have to come to is some sort of a half a page very clear statement that has non-legal language. Perhaps the last recommendation of at least initialing the both sides of the disbursements would make sense.

Secondly, probably buyers should probably be partially protected against foreclosure if they continue to make monthly payments in accordance with initial contracts. I think something is going to have to be done about foreclosures under balloon payments. This would indicate either some form or moratorium or get a lawyer to protect... perhaps strict foreclosure rather than sales under deed of trust with the protection of the court using their equity powers.

Third, it seems to be clear that there is a need to make certain that payments go against the underlying debt, and that right to the title are clear so that there ought to be legislation in that area.

Fourth, in terms of the second mortgage problem, again I'm not clear why there is the difficulty of criminal proceedings when we see the type of ads we see which would apparently, to me at least, not be authorized under most corporation laws. I'm not clear what the problem is of the law, but it seems to be clear that on the face of it there is some need for legislation. Something is wrong with it.

Having said that let me go into the background a bit. I think in any type of consumer protection there is a tremendous need to balance the need for the protection against the need for the lending. In other words, you have to look very carefully at why this is occurring. One obvious point is that prospective borrowers can't qualify for other types of borrowing, and therefore they are using creative financing. There is a shortage of funds in lending institutions so that there is a need of another source of funds in the market. Buyers and sellers find it easier to come to terms if they can bargain over the financing rather than over the price, in other words, the seller kids himself that he's getting a higher price. He's not willing to take a lower price, and therefore it becomes easier for the borrower to buy. In terms of other things, investors are speculators allowed to use maximum leverage to control the largest amount of property with available funds. It seems to me all of these are very logical reasons, and therefore you have to be very careful in drafting legislation to make sure that you don't make it too difficult for this type of creative finance to continue, because I think it is a necessity.

Now in terms of the economics, it seems to be clear that many people are making incorrect assumptions about future interest rates, money availability and housing prices. In other words, the underlying theory of most of these deals is wrong. People seem to assume mortgage interest rates will be lower and they will be able to refinance sometime in the next three years, but this is not what the experts think. You can buy a Ginnie Mae contract in the market three and one-half years from now for only two and one-half points above current Ginnie Mae rates. What that means is that the mortgage market as a whole is betting that interest rates won't fall by as much as one percent over the next three and one-half years. And anybody who thinks the mortgage market is wrong, they'll take bets up to $20-$30 million overnight without any difficulties, so that it just seems to me that if people want to gamble it would be cheaper for them to gamble in the organized market or in Reno rather than taking this sort of risk they are taking.

ASSEMBLYMAN COSTA: Your statement then is that you don't believe interest rates...

MR. MAISEL: I'm saying that most financial firms in the United States do not believe it because they are in the future's market. They are selling contracts three and a half years out at interest rates at less than one percent under today. And if money firms felt the opposite that market wouldn't be being made.

ASSEMBLYMAN COSTA: Today's interest being?

MR. MAISEL: Today's -- these are interest rates at 15 percent compared to 14 percent. In other words the rate three and a half years from now is only about a 14 percent.

ASSEMBLYMAN COSTA: I'm glad you told me. I have a wager with a known lobbyist in Sacramento on whether interest rates would drop below 12 percent or not.

MR. MAISEL: Well, they may, but if you want to hedge your bet you could easily hedge your bet in one of the best organized markets in the country.

ASSEM BLYMAN COSTA: I have a steak dinner on it.

CHAIRMAN BOSCO: I just wished they'd get reapportionment settled soon so that we can all move and buy our houses. Talk about poor sales. Go ahead. (Laughter)

ASSEMBLYMAN ROBINSON: ...some real creative financing.

ASSEMBLYMAN MCALISTER: There seem to be a number of condominiums for sale in Riverside.

CHAIRMAN BOSCO: I didn't think it would be that bad.

MR. MAISEL: The second part is that people don't realize how volatile mortgage interest rates are. If you look at the last three years of Ginnie Mae contracts, they fluctuated by over 30 percent, which means that interest rates of the last three years have fluctuated by over 50 percent. This is what has happened to the main mortgage market over the last three years. There's been over 50 percent fluctuation from high to low and all that we can say though is that the price that rules today is what the majority of the market, or the average of the market thinks. In other words, the picture is that there is a market now for loans to be made three years from now. That market price has to be the middle of what the average person in the market thinks. Those who think the market price is wrong should be buying or selling...

ASSEMBLYMAN COSTA: And that price is?

MR. MAISEL: That price, I'll say, is a little over 14 percent. It's also bad for U.S. government bonds, it's roughly the same. The market applies to U.S. government bonds of 20 years or to Ginnie Mae mortgages.

ASSEMBLYMAN COSTA: Is that a general rule of thumb? Has it been accurate in the last ten years?

MR. MAISEL: No, what is accurate is that you cannot show that anybody could have used any other information to beat the market, but the market turns out to be wrong. The fluctuations are wide around the average. But there is no way of saying I want to be average in beating the market. That's more than a rule of thumb. There's several hundred studies that show this is the case. What the market reflects on any day is an average of what people think. It turns out a year from now we'll know the market was wrong. You couldn't have had 50 percent fluctuations in the market if the market was right. So people will be wrong, but there's no way of saying I know that the market is going to be wrong. You can bet aginst the market but you have to assume that what the market is saying today is the average of what everybody who was in this market thinks. And this, as I say is most of the large institutions in the country. Most of the large banks, most of the large mortgage firms and so on.

The third point along the same line is that there is no reason to assume that housing prices will continue to rise as they have in the past faster than the average interest rate. In other words, if we look at the housing market historically we know two types of things. One, when housing prices have gone up much faster than the inflation rate for a period, they tend to go up slower than the inflation rate. During the last ten years they have tended to go up much faster than the inflation rate primarily because there were negative real interest rates after taxes in the market so that anybody buying in that market was getting a subsidy from the U.S. government to buy the house. This tended to drive up housing prices. Again what we would have to assume then, if we look at history, is that over the next ten years what should prevail is the rate of inflation less some, instead of plus some. In other words that housing prices should go up slightly less or somewhat less than the rate of inflation, so that anybody who is betting that they will go up faster than the rate of inflation is simply projecting the trends of the last ten years which are not correct, historically.

And the fourth point is that there's no reason to assume that institutions will have more money. Again if you bet that institutions will be able to do this as Tony Frank said this morning, you're going against the whole philosophy of this administration which, in effect, is trying to see that money goes for other purposes out of the housing market. So there is no good reason it seems to me to bet against the President. He's been very effective in making his points legislatively, and in other ways. I wouldn't suggest that anybody bet against him.

ASSEMBLYMAN COSTA: You agree with all the statements that have been made this morning.

MR. MAISEL: Yes.

ASSEMBLYMAN STIRLING: Dr. Maisel, your assumption then is there's a fixed universe of capital in the United States and the pie is simply being split. Isn't it possible that because of the free floating interest rates that capital might immigrate to the United States and therefore, increase the universe available. And, therefore increase the supply for home mortgages eventually?

MR. MAISEL: I don't think the orders of magnitude are...

ASSEMBLYMAN STIRLING: Is the capital appetite in the commercial and governmental sector such that it can't filter down to the home mortgage market.

MR. MAISEL: It can, but the emphasis is the other way.

In other words, the tax bill in effect makes it extremely profitable to make capital investments this...

ASSEMBLYMAN STIRLING: It also makes it profitable to invest in home mortgages. What is the bill that is just being considered now, the all-lenders, all-savers bill?

MR. MAISEL: No, if you're talking about the special saving certificates, this says it's profitable to move your money out of an existing certificate into the new certificate and you get...

ASSEMBLYMAN STIRLING: Seventy-five or 80 percent of that is earmarked for home construction or home loans.

MR. MAISEL: No. My understanding of the bill that passed is that it says that for the next year savings and loans can issue savings certificates in which investors have to pay only 70 percent of the rate they would otherwise have to pay so that somebody in the 40 percent or higher tax bracket gets a tax break by putting his money into that as opposed to other types of certificates, but I don't think that this really amounts to very much.

ASSEMBLYMAN STIRLING: Back to my original question. You don't think that floating interest rates will cause capital to immigrate into the United States?

MR. MAISEL: As I say, I don't -- no, because the rates in other countries have to adjust, or the exchange regulations of other countries have to adjust. Otherwise, you begin to get very large transfers through the money markets. We've had it already. You drive the exchange rate against those other currencies down and the farther you drive them down the more difficult you make the transfer of money, so that the orders of magnitude compared to the amount of new money we lend in this country every year, I don't think they're important.

ASSEMBLYMAN STIRLING: Thank you.

MR. MAISEL: Mr. Chairman I would be happy to answer questions. I could go on, but I know you're pressed for time.

ASSEMBLYMAN STIRLING: A basic question would be, given the fact that even though California's ten percent or approximately, of the gross national product of this country, are there financial policies that are implementable by the State Legislature that could do anything to militate against this depreciation of the home mortgage market or housing availability in California?

MR. MAISEL: As I say I think there are. If I were in your position, my first action would be to try to protect people who are taking creative financing. Because I think it is a necessity that it continues. It seems to me that the first critical thing is to make sure that they are aware fully of what they are getting themselves into. Secondly, ...

ASSEMBLYMAN COSTA: We can do that prospectively. How do you take care of the problem that -- of those who have already jumped in?

MR. MAISEL: It seems to me that you have this question of some kind of moratorium over foreclosures of balloon payments. It seems to me, as a minimum, you have to insist that they continue to make payments as they were agreed to, although in some cases there were no payments agreed to. We had cases that were just cited where, in effect, you funded the interest rates and made no payments, so you're going to be in difficulties doing it, but it seems to me you can't put a complete moratorium or you'd go into the point that was made this morning that you are creating problems. But it does seem to me that we are in a situation where you might want to think of certain types of moratoriums.

CHAIRMAN BOSCO: Mr. Robinson.

ASSEMBLYMAN ROBINSON: Doctor, you mentioned something at lunch that I want to bring out. Is it your professional opinion that the existing system, and by that I mean prior to the deregulation move in Washington starting with the last administration, were we allocating a certain component of credit to the housing market, and would the end result of deregulation, the repeal of Reg Q and what have you, be to remove that credit allocation, so that there was no special pool of money for the housing market.

MR. MAISEL: As I told you earlier, my opinion is that we were allocating credit, that it was successful by probably lowering mortgage rates somewhere between one-half a percent or one percent under what they otherwise would have been. But as high interest rates have come along, as the deregulation has come along over the last six or seven years, that one-half to one percent has been disappearing and it may have disappeared completely. That's my opinion. I would also say that the average person in the field would probably not have agreed that it was that large.

CHAIRMAN BOSCO: Thank you very much, Professor. We appreciate your testimony. We will now have Doug Gillies for the defense. Oh, excuse me Mr. Gillies. Apparently we have one witness who has to leave by four o'clock. Maybe we'll take him first, if he's here. Ken Rosen, who's the Chairman of the Center for Real Estate and Urban Economics, University of California, Berkeley.

<u>MR. KEN ROSEN</u>: Thank you very much for putting me up front here. It's going to be hard to match Sherman Maisel's excellent performance. But...

CHAIRMAN BOSCO: You think that's bad. What if you had to follow Mr. Gillies!

MR. ROSEN: Basically my testimony is probably a little bit different than some of the other things you've heard today. I'd like to talk about the restructuring of the housing finance system and put creative financing in that context, because I think that you have to look at the overall dramatic changes that are occurring in the mortgage market and what effects that might have on the market for the next five or six years.

What I'd like to talk about first is to look at extensive creative financing and how much is going on relative to, let's say, the past, then talk about the changing sources of mortgage credit. And lastly, give you a potential solution to existing mortgages and existing lower rate mortgages and second or third mortgages given by sellers or other credit companies to the buyer of the house. So I assume it is a similar definition probably not exactly the same but quite similar.

These estimates come from basically two sources of data. The Department of Housing and Urban Development puts out data on new mortgage originations that are being made. And then one can calculate the absolute value of activity taking place by taking the number of home transactions times the price times the average loan to value ratio. So by comparing the two you can tell how many mortgages are being assumed, dollar amount, and also what sort of seller financing must be going on. So what this means is that essentially at least half of all existing home transactions involve this assumption of mortgages or seller creative financing. At least half, at a minimum, obviously a very extraordinary, phenomenal growth.

In terms of net mortgage extension, if you want to turn to Table 2, it shows there's been a dramatic decline in net mortgage extension by traditional lenders. And this really confirms this restructuring of the market. Commercial banks, savings and loans share of the mortgage market used to be about 65 percent in 1978, there's a net credit extension that's dropped to about 44 percent in 1980 and this is partly because they haven't been able to attract the deposits because of money market mutual funds and other things like this, partly because of the inflexibility of the present or the previous sets of instruments. And in place of that has risen up another type of creative financing which is different than the seller financing we're talking about or assumable mortgages and that's mortgage pools, whereby first mortgages are pooled up and then sold on a secondary market. And this is a Ginnie Mae pass through security. Some of you may be involved in the Callie Mae program that people are working on here. These pools are now just about the primary source of credit in terms of net mortgage extensions nationwide.

CHAIRMAN BOSCO: That's the subject of our hearing tomorrow.

MR. ROSEN: Right. I just wanted to let you know that that's the change of structure you are seeing.

ASSEMBLYMAN ROBINSON: These are national figures now.

MR. ROSEN: These are all national figures. California numbers are not available on this sort of information. Lastly let me give you what I think is the seller and lender's problem. And, basically there are really two separate problems. For lenders, we have a profitability crisis. That is, lenders stuck with these old mortgages which they've made from one to five years ago, are stuck with mortgages that are far below market rates in many cases and they are now having to fund the liability side at market rates. So we have a profitability crisis for many lenders. Almost all savings and loans in California are losing vast sums of money, and the same thing is true of commercial banks who hold these, the creative financing problem, if there is a problem as such, and the problem of affordability of housing for first time home buyers, and the difficulty that many lenders are facing in the market. It's a tall order but I'll try to do it quickly.

Basically, as you realize, the last couple of years has seen a dramatic restructuring of the housing finance system in California and throughout the country. And this restructuring is really a function of the interaction of market conditions and a strong deregulation effort on the part of the federal government. The market conditions have been characterized by extraordinarily high and volatile interest rates, both short and long term interest rates.

ASSEMBLYMAN STIRLING: Dr. Rosen.

MR. ROSEN: Yes.

ASSEMBLYMAN STIRLING: With all due respect, sir, if you would just tell us that you felt rather than reading that thing, please.

MR. ROSEN: Basically, the situation is that this deregulation of the deposit side for savings and loans and commercial banks is preceding very rapidly. Much more rapidly than I think anyone anticipated two years ago. It means that at the moment savings and loans and commercial banks have to pay market rates on approximately 70 percent of their deposit accounts. And those market rates fluctuate weekly with the Treasury Bill auction. That's created a situation where basically the asset side of the savings and loans and commercial banks also has to be deregulated. And at the federal level this spring new mortgages were authorized for the savings and loans and also for commercial banks which give both basically essential freedom on the asset side for new mortgages, especially variable rate mortgages that move completely with market rates. So we're in a situation now, where we have completely flexible rates or nearly completely flexible rates on the deposit side for the federal chartered institutions -- on the asset side. Now what this has done, this deregulation environment, is really what you have to look at in terms of why creative financing is occurring.

Creative financing itself, just to give you some idea of how much has occurred, my estimate is that, if you want to turn on page 4 of the testimony, there's an estimate of how much has occurred. Traditionally in 1970 through '78 only about 15 percent of transactions on existing homes involved creative financing. By my estimate...

ASSEMBLYMAN ROBINSON: Doctor, you're using the same definition on creative financing that has been used by our previous witnesses.

MR. ROSEN: Well, I'm not sure since I wasn't here. I'll tell you what my definition is. This is basically assumptions of mortgages, these old mortgages. At the same time the buyer has a terrible problem, an affordability crisis. Because of these high mortgage rates you have buyers unable to qualify for new mortgages. Someone trying to buy a house now cannot qualify for a 17 or 18 percent mortgage rate or 16 percent mortgage rate. So you've got a terrible situation for both the lenders and borrowers. And it seems to me that there has to be a solution other than creative financing to this problem. And so what I propose in the last page of this testimony is a solution. And the solution I've been working on for six years and finally, one month ago the Federal Home Loan Bank Board was authorized to this solution.

CHAIRMAN BOSCO: Congratulations.

MR. ROSEN: Now let me tell you what the solution is. And I think that a number of lenders have started to make these mortgages, and borrowers are overwhelmingly positive about them. The lenders who are making them, there is one in California and one in New Jersey and others are thinking about it, have overwhelming applications for this new mortgage. And basically the mortgage is something called a dual-interest rate mortgage. A dual-interest rate mortgage. And what that instrument does is set two different interest rates. There's an accrual interest rate set which is basically a short term interest rate plus some premium. That interest rate is variable and can be varied every six months and it's usually keyed to a treasury bill or an intermediate treasury security. So it's a variable rate mortgage on the accrual amount on the loan outstanding. The second rate is a payment rate which the borrower pays and that can be set at a number of different levels, but is usually set in the present environment, probably 300-500 basis points below the accrual rate. That rate can be set on a graduated basis. That it might be set at let's say at 10 or 11 percent today but then it would go up one percent a year until it reaches that market rate. Or alternatively the market rate might very well most likely fall in that time period. The net effect of this, the difference between the accrual rate and the payment rate, which may be positive as it is now or may be negative, is added or subtracted from the principle outstanding. This instrument, I call the dual-interest rate mortgage, a variation of this is something called the graduated payment adjustable rate mortgage. And that is what the Federal Home Loan Bank Board has authorized. This instrument is used in Canada and a number of other countries very successfully and is used in England.

ASSEMBLYMAN ROBINSON: Is it a Canadian rollover which turns over in five years?

MR. ROSEN: A Canadian rollover is a different instrument. But they also have this graduated payment adjustable rate mortgage.

ASSEMBLYMAN COSTA: It can be one, three or five years?

MR. ROSEN: This is not a rollover mortgage.

ASSEMBLYMAN ROBINSON: To what degree is there negative amortization? It seems to me that given the current economic environment with that scheme you're going to have a negative amortization.

MR. ROSEN: If rates stay exactly as they are now, for the first year you would have 500 basis points; the second, you would have four; and it would decline. But of course rates will not stay where they are now.

ASSEMBLYMAN COSTA: Where are they going?

ASSEMBLYMAN ROBINSON: You disagree with the last witness then. Your colleagues?

MR. ROSEN: No, I'm not disagreeing at all with him. He's talking about the futures market in terms of mortgage rates, but the short term treasury bill rate, which is the accrual rate, they have a very sharp decline in the treasury bill rate on the future's market. They expect the treasury bill rate to be on the order of 11 to 12 percent...

ASSEMBLYMAN ROBINSON: They believe the administration.

MR. ROSEN: No, no it's the same market. It's exactly the same market except for treasury bills. And what I am saying is with the changes in the regulations that you've had on the asset and liabilities side you've got to change the mortgage to both to make it more palatable for the lender and for the borrower.

ASSEMBLYMAN COSTA: We understand that, but what prediction are you making toward the interest rates?

ASSEMBLYMAN ROBINSON: I want to follow this. What would happen if this instrument has been in place in 1960 in California?

MR. ROSEN: Okay, I would suggest that you could do a simulation. They have done simulations. I would suggest that you would probably not have any more defaults on this instrument than any other instrument.

ASSEMBLYMAN ROBINSON: No, I don't think defaults. What I'm worried about is the negative amortization.

MR. ROSEN: You have negative amortization, but the typical household would have accumulated tremendous amounts of equity in the property. So, what you would have...you would accumulate less equity...

ASSEMBLYMAN ROBINSON: So what you have had is a shared appreciation of mortgage documents.

MR. ROSEN: If you have an upward trend -- No, it is not a SAM. But if you had an upward trend in interest rates on the short side, and if you did not graduate the payment rate enough you could very well end up with something that looks like a shared appreciation mortgage. It's not shared appreciation because it's not indexed. But it's something like that.

ASSEMBLYMAN ROBINSON: The escrow closing would look very closely like this shared appreciation.

MR. ROSEN: No it isn't. Because shared appreciation depends on the property value itself. But for the lender it would have the same sort of thing. And for the borrower. The borrower has to realize that he would not be accumulating equity as much as he would otherwise. So there has to be a complete disclosure statement. However, it turns out, it's going to be a very popular mortgage with borrowers. It's been offered by City Federal Savings and Loan in New Jersey which is the largest savings and loan. Something like this has been offered by San Diego Federal here in California. And what I'm emphasizing to you, is that the state ought to basically authorize something like this because I think it would eliminate much of the need for the creative financing. Lenders would want to participate because they could trade one of their low rate old mortgages for this new mortgage. Borrowers would want to participate because they basically can get into the market and buy a house. This instrument is not counting on inflation to 10 or 20 percent to make it work out. If you had, let's say, a situation where negative amortization occurred at five percent a year you generally require a five percent appreciation per year to make this break even for the borrower. And I agree with my colleague, Sherman Maisel, that inflation in housing would be roughly at the inflation rate over the next ten year period.

So this instrument, while it's more risky than the present one it's the only instrument that I think can help both the borrower and the lender. And as far as I'm aware this is not now authorized for California or state chartered institutions to make. It is authorized for federally chartered institutions and I think you're going to see this as a popular instrument which may eliminate the need for much of the creative financing. And we may consider this creative financing as well.

ASSEMBLYMAN ROBINSON: I guess my first question is, where do the funds come from? The total amount of paper that is nine points and below in California chartered savings and loans, or in banks is very substantial. Where is the money coming from the finance this in lieu of creative financing? Where is the influx of cash coming from?

MR. ROSEN: There are two aspects of creative financing. One is the assumption of the old rate mortgage. The second is an extension of a mortgage by the seller. On the assumption of the mortgage there's really no difference in the amount of money involved, very little difference in the amount of money. The seller financing may still have to occur to some extent if the financial institutions don't have that sort of money but...

ASSEMBLYMAN ROBINSON: Do you agree that the impetus for creative financing is coming from the Wellenkamp decision together with the dollars of funds available to lend by the legitimate or prime lender?

MR. ROSEN: I think that's essentially correct, that the Wellenkamp decision makes it very desirable to assume an old rate mortgage. I think there is an incorrect perception on the part of sellers that they would rather take that mortgage paper than lower their price. In essence, in a free working market where the people are rational there shouldn't be very much difference. So, if you give some back at 12 percent on a mortgage and the market rate is 17 percent, you're giving that person a subsidy for three years or whatever.

ASSEMBLYMAN ROBINSON: I know, but I'm just trying to understand where the money is going to come from. The prospective buyer that right now is encouraged to use creative financing because of that dual situation, how does this relinguish some of that pressure?

MR. ROSEN: I'll tell you why. There is no problem with this instrument. If this instrument is done correctly, there will be a secondary market and as I showed, the largest source of credit today is coming from that secondary market. The Federal National Mortgage Association, on much effort on my part, has agreed to purchase this mortgage.

ASSEMBLYMAN ROBINSON: At what discount rate?

MR. ROSEN: About a half...50 basis to 60 basis discount from a fixed payment mortgage. There is an organized market that already discounts this type of mortgage and it's by 50 and 75 basis points. I think this is testimony I would like you to take a look at carefully, and see if you might think this is an option.

ASSEMBLYMAN MCALISTER: Could I interrupt here? The dual rate interest mortgage as I understand it, it's kind of a form of a graduated payment mortgage?

MR. ROSEN: It combines the graduated payment feature with the variable rate feature. The graduated payment feature is what the borrower must have in order to get into that market, a borrower who cannot qualify for the 16 or 17 percent initially. But because of inflation after five years a borrower can afford higher payments. Probably 10 to 11 percent is what most first time buyers can afford.

ASSEMBLYMAN MCALISTER: You're in effect working toward a goal which is about five years ahead, and presumably gets higher by then.

MR. ROSEN: What inflation has done is to increase mortgage interest rates, but it does not take into account the fact that incomes rise roughly half to one time the inflation rate every year. So the present fixed payment mortgage is really bad for both the borrower and the lender. The lenders understand that. The borrowers also understand that, I think in many cases, because the fixed payment mortgage basically tilts their payment stream so they have to pay a lot of the interest up front and it basically skews their payment path over time and makes it very difficult to qualify. And that's why this combination, I think, helps both borrowers and lenders. We have to see if the market accepts it, but it does look from the initial reaction the market, from both sides, likes these instruments.

ASSEMBLYMAN COSTA: You weren't here this morning, but in essence this is really the blended rate concept that Fannie Mae is currently undertaking. Is that not correct?

MR. ROSEN: The blended rate concept that Fannie Mae is undertaking is somewhat different. But what they are trying to do basically is get rid of those old mortgages on their books. This is a different instrument because it is basically starting those payments. It's a new mortgage first of all. And it...

ASSEMBLYMAN COSTA: On the blended rate in the form of a new loan, doesn't that become a new mortgage?

MR. ROSEN: It would. But the blended rate I don't think is a graduated payment.

ASSEMBLYMAN COSTA: You could adjust it so once you blended the rate that you could put it on a ARM or a VRM or whatever, which is what Tony Frank suggested in terms of middle grounds approach between my Wellenkamp legislation instead of doing that to meet the middle ground, to allow an interest rate where a homeowner could afford, at this point in time, blending the two rates together and then giving it the vehicle of an ARM or VRM so that it gradually reflected the current trends of the market.

MR. ROSEN: I guess it does sound similar. Fannie Mae considers this a different instrument because they have a purchase program for this one different from their other program.

ASSEMBLYMAN COSTA: Do you believe this instrument has advantages over their blended rate instrument, and I guess the second question I have is, do you believe either the dual interest rate mechanism or the blended rate ought to have a prospective due on sale clause within it?

MR. ROSEN: I think the differences really are technical. Basically you can come up with any sort of combination under this dual rate rhetoric depending on where you set the initial interest rate and where you set the accrual rate. I think probably they are very similar. You need no due on sale clause in this instrument believe it or not. Because you have the fluctuating rate. The only reason you need due on sale is because of two things. One is that we have had a tremendous up trend in interest rates. If the trend were flat you wouldn't need due on sale either. But in this instrument, I perceive you not needing a due on sale. I don't think lenders will require it.

ASSEMBLYMAN ROBINSON: How about prepayment penalties.

MR. ROSEN: I would suggest that in this instrument there probably would be a small prepayment penalty to cover transaction costs in early years, but I would presume that the prepayment penalty would drop to a very small amount after three or four or five years.

You have to cover some transaction costs and I think that's the reason you would want one. In this particular instrument the lender's going to get market rates and the borrower is basically going to get below market rates for a short period of time, but then will be going up to market rates as his income rises.

ASSEMBLYMAN STIRLING: Dr. Rosen, is there a loan to value ratio test in your instrument?

MR. ROSEN: There isn't one. You could certainly put one on so that you don't want to be in a situation where you have so much negative amortization over 100 percent. But given any reasonable assumptions on the economy that even if house prices go up only half the inflation rate on average and you start with a loan to value ratio between let's say between 80 and 90 you're really not going to have any problem in most cases as long as you have an honest appraisal. Again, you're always going to have cases of fraud and deception with any instrument. I think this one is really no more subject to that or not much more subject to that than the present instrument.

ASSEMBLYMAN STIRLING: As for concern over the long term, I think what you propose is a good idea. It's absolutely consistent with the blended rate and that sort of thing, but I'm concerned over long term that buyers could end up owing their souls to the company store and not have a way out of it.

MR. ROSEN: I think that in the vast majority of the cases that is not likely. One might want to put a cap that you could not go over 95 percent or 98 percent or something like that of the value and have an appraisal once every two years or something like that.

ASSEMBLYMAN COSTA: Do you think the caps are important?

MR. ROSEN: I don't think so. Given what I perceive as market conditions that are likely, I would say that the number of cases you have that would violate any restriction like that would be very small unless there was actual fraud. So I think you wouldn't have that as a real problem.

I think the other thing to say about this is it's very essential that consumers understand this instrument. And as long as they understand that they may not build up equity as fast, I think there shouldn't be any problem with consumer acceptance. And again initial experiments, talking to people both in San Diego and in New Jersey, public acceptance is just overwhelming. They just have tremendous numbers of people who want this lower initial rate and are willing to take the variable rate feature with it. As you know there's been some suggestion that the full variable rate mortgage will not be accepted by consumers. This is a way to get, I think, the consumer benefit and the lender benefit. And again we'll have to see if lenders and consumers like it, but it seems to me we ought to try for this sort of thing.

ASSEMBLYMAN ROBINSON: You're not suggesting any caps on interest rates then on either one of the rates.

MR. ROSEN: I think...

ASSEMBLYMAN ROBINSON: The cap you suggested is the prudent one that is normally enforced by the federal, various regulatory agencies that they can't lend more than 100 percent of the values.

MR. ROSEN: That's right, basically that.

ASSEMBLYMAN STIRLING: I guess the reason I raised it is because I remember the time in San Diego when Aerospace moved out, and people had to walk away from their homes...

MR. ROSEN: Yes, but that was with a fixed payment mortgage.

This could add a small amount extra risk, there's no doubt about that, to the process. But the amount is very small. We're really talking about during any sort of normal period. Now's the most abnormal period you have ever had, and we're talking about a negative amortization of five percent. But the present situation just won't last for more than a year or two. It's also much less complicated than all these creative financing schemes, and much less subject I think to consumers' misunderstanding.

ASSEMBLYMAN STIRLING: Is there an imbalance between the increase in home values in the non-sunbelt states versus the sunbelt states? Does a house appreciate as fast in beautiful downtown Akron, Ohio as it does in San Diego?

MR. ROSEN: Well, in the last five years California house prices have gone up basically two and three times faster than other parts of the country. But I think that was due to two circumstances. One, we had a tremendous immigration of people from the rest of the country as we had a very strong employment growth in the late 70's. The second, we had a set of lenders' controls proliferating around the state where building was very difficult, so you had a big increase in demand without the supply increasing. So you had prices driven up in California relative to other places. This is not true in other sunbelt states. It is not true in Texas where it's easy to build, it's not true in Florida and it is true in places such as Washington, D.C. and certain parts of New Jersey where they do have lending restrictions, so I think the blame is on land use.

ASSEMBLYMAN STIRLING: Let me give one observation to you and you tell me whether it seems right or not. I have discussed this with a lot of people in the past, the fact that the federal government subsidized housing construction and employment in this country. The public didn't really win on that. The trade unions won, the savings and loans won, the realtor won, but the public did not win. By and large the more money made available the more it was absorbed in labor agreements and mortgage points and in the amount charged by the realtor to sell it. Do you believe this?

MR. ROSEN: No, I don't think that's true. I think that if anyone has absorbed this rise in prices it's been land cost. The only major component of housing other than mortgage financing that has risen in price dramatically has been land. It's not labor; it's not construction materials; it's land because basically local public policies have restricted the growth of activity. In terms of what I think might happen in the future in this regard, I think there is a perception in California that our problem has been of land use policies. And I think that has been the main problem.

ASSEMBLYMAN STIRLING: We just commented on that. I have heard that rhetoric time and time again and to an extent I agree with it, but I want to tell you about a factual matter in San Diego county. The major tracts of land are owned by about six major owners. And there's some indication that they're doing what the DeBeers do with their diamonds. They just simply feed it out as they can see the market absorbing it.

MR. ROSEN: I think that there certainly could be something there in terms of supply of land. In the San Francisco Bay Area which is the one I am most familiar with, it's definitely local public policy. It's proven by at least a half dozen studies that that really has been the major cause of this rise in prices.

CHAIRMAN BOSCO: I simply want to remind the members that our hearing is really not on all the problems in the housing market but simply on creative financing. Mr. McAlister.

ASSEMBLYMAN MCALISTER: That's very true, however, if we really were to strike a blow for truth and justice it may well be that the best blows we could strike would be at these restrictive land use policies. In doing so, we may have to run counter to some other values that many of us cherish, such as local control, as well as the still strong political attachment by many segments of the state to restricted growth, or no growth and environmental values, and so forth. At some point we may have to decide which are the most important values. I tend to agree that these land use restrictions that are largely imposed on the local level are the single most important factor in the skewing of the situation in California as related to the rest of the country. You can travel through the country and there are only a few other parts of the country that in anyway resemble our ridiculous real estate situation.

MR. ROSEN: In 1970, house prices in California averaged the same as the rest of the country. At the present time they are about 60 percent higher. And it's coincident with land use controls.

ASSEMBLYMAN MCALISTER: I think in the Bay Area it's more than 60 percent.

MR. ROSEN: Double.

ASSEMBLYMAN MCALISTER: To get that you include places like Dinuba and Needles.

ASSEMBLYMAN ROBINSON: Needles is not in the Bay Area. Reapportionment might bring Needles though to the Bay Area.

ASSEMBLYMAN STIRLING: I'm not sure it's local control only because CEQA (California Environmental Quality Act) and the map act and the general plan requirements are all state imposed mandates.

ASSEMBLYMAN ROBINSON: You left out the Coastal Act, Mr. Stirling.

ASSEMBLYMAN MCALISTER: The state bears a share of responsibility. The Supreme Court of course interpreted CEQA more restrictively than I think the Legislature intended it to be applied. I'm not sure what we do about all this, but seemingly this would be a place to strike a blow.

MR. ROSEN: I think a balance is needed clearly because I think some of the positive features of land use controls and the environmental movement have to be protected as well, but I think we've moved to one extreme. I think we might need to move back towards a balance realizing that if California's economy is to grow and if we are to provide housing at a reasonable cost for people, both new and existing, we really need some sort of reversal in those policies. I think there was a start last year by the Legislature in that regard.

ASSEMBLYMAN ROBINSON: Would that include rent control?

MR. ROSEN: No.

CHAIRMAN BOSCO: I think that you realize now the futility of trying to direct these types of discussions at one of these hearings. We do appreciate your testimony very much, Professor Rosen. We have a bill moving now that would allow state chartered savings and loans to use virtually all instruments that the federal government allows, so that could very well, if it passes, encompass yours. I think it's probably likely at some future time that we would want to again ask for your assistance when we review some of these instruments.

MR. ROSEN: Thank you very much.

CHAIRMAN BOSCO: Thank you. Here comes Mr. Gillies. I hate to say this Mr. Gillies, but the Commissioner of Real Estate is here and he interrupted his vacation to be here. I have agreed to allow him to come on first, and then we'll take your testimony. Commissioner...

MR. FOX: Thank you. I appreciate your accommodating my schedule. At the same time I think it's a little bit dangerous letting Mr. Gillies speak after me.

To me, the term creative financing doesn't have any precise meaning, and our meaning is any method to finance real estate purchases other than long term fully amortized, fixed or adjustable rate interest loans. Basically, most creative financing transactions have been built around three basic assumptions; first, that mortgage loans will be available to the buyer at lower rates when the balloon payments for seconds or thirds mature in a short rate of time; second, that the buyer's income will increase sufficiently in this short period of time to qualify for a conventional loan when the balloon payments are due; and third, that real estate will continue to rise at substantially the same rate as inflation has occurred during the last few years.

I believe that if any one of those three presumptions does not come true, that thousands of home buyers that have bought their homes recently and are buying them now through creative financing mechanisms stand to lose their homes through foreclosure. Also, the creative financing business is conducted in often a nonregulated environment and most of the buyers and sellers are unsophisticated. They lack the fundamental benefits of full and detailed disclosures of the true cost of financing, and what their responsibilities and liabilities really are in these transactions. It seems to me that many of these buyers and sellers are basically, because of market conditions, forced to gamble in a game of real estate roulette where the house odds are stacked against them. And this may come to pass more and more in 1982 and 1983.

ASSEMBLYMAN STIRLING: Excuse me, Mr. Fox.

MR. FOX: Yes.

ASSEMBLYMAN STIRLING: You heard some of the previous testimony, especially from the attorneys. They indicated that the realtors are in a really dangerous position now as people start looking for scapegoats on the transactions that have gone sour. They're going to be back after folks that you license. Are you recommending any corrective steps to either insulate the realtors or improve their professionalism or their sustainability in a law suit to kind of correct this problem.

MR. FOX: Well, basically the realtors have the obligations of making full disclosure of all material facts in a real estate transaction. That's an existing legal burden that they have. And we have found that in a vast majority of cases they are in fact, complying with that responsibility. There are some real estate licensees that have acted in fraudulent ways and have engaged in dishonest dealings through these creative financing schemes...

ASSEMBLYMAN STIRLING: The ones I am aware of are folks that have been realtors for years and understand how to walk the streets and get a listing and how to make showings and how to make the sale. But what's confusing to them and everybody else in the entire world right now are the financial instruments that are available to them. There's no way, I think, unless the person has to be an expert. If they don't get many listings they are not going to be up on that. So I don't think it's intentional. I'm just wondering if the professionalism and the licensure of the mortgage brokers and those sorts of things, in-service training, bonding and that sort of stuff are being proposed by your department to preempt this problem.

MR. FOX: We have examined some of those suggestions. The bonding is heavily opposed by the mortgage loan brokers. And , we had to delete that from some legislation, Senate Bill 391.

ASSEMBLYMAN STIRLING: But you did propose it.

MR. FOX: Yes, we did propose the bonding. We also proposed a separate endorsement on the real estate license for mortgage loan brokers. That was heavily opposed by the CAR. And so that was also deleted from the legislation.

ASSEMBLYMAN STIRLING: How about the arms length transaction between the broker and the escrow agent?

MR. FOX: We haven't made a proposal in that area yet, the idea of the independent escrow, because I haven't seen enough evidence that there is really substantial harm because there are broker owned escrows in some of the transactions. However, that's really the basic problem, the terms of the creative financing transaction. The independent escrow company is there simply to facilitate the transaction, and they don't have any authority over the terms of the transaction. So I'm not sure if that would be appropriate. At the same time, to the extent that the realtors feel that they need more guidance, they have extensive legal staff of their own and they have very well respected legislative capacity to seek new legislation if they feel that it's in the best interest of the profession. So I am looking to them for leadership in that area in terms of required courses, for example, or some kind of established guidelines. I haven't heard from the realtors yet in that area.

ASSEMBLYMAN STIRLING: Well, the question is whether, in the public interest, there are problems emerging that, irrespective of whether CAR recommends further encroachment on their freedom, whether the Administration's got recommendations.

MR. FOX: You started talking about them as potential scapegoats and whether or not they were in a disadvantageous position.

ASSEMBLYMAN STIRLING: My basic concern, I think, and everybody else here, is about the public, the unsuspecting public. And I'm not indicting at all the quality or motivation of every realtor that I know personally. I'm only alluding to the potential for these balloons popping and then the realtors looked to for scapegoats. Both people lose, the realtor and the public.

MR. FOX: I think that there is an issue of more disclosure to the public about exactly what a home buyer and a home seller are going to...about what the potential for harm is. It might take the form in some kind of a written disclosure that they have to sign off on that they've read and considered. But even in that area people, in my experience, when they are buying homes or selling homes have their minds made up and they go ahead and purchase and gamble even if you tell them that the odds are against them. It doesn't seem to have a lot of impact. We issue a public report on new subdivisions. A lot of time we talk about the potential problems, and people have been buying the homes and ignoring the problems without paying much attention to them because they've decided to purchase.

And as I said earlier, they're gambling that interest rates will reduce in the future, that their income will increase or that there'll be some kind of a new mortgage instrument available that they can make use of, or that the home value will appreciate sufficiently so that they can refinance in two or three or five years. I think those are the basic considerations that the public has in mind. More disclosure would help, but I don't really think that is going to be the solution.

CHAIRMAN BOSCO: You know, I have to agree with you on some of those points. I think when people want to go and buy a home that's all they have in mind. We have more disclosure now than we have ever had, it seems to me, under federal and state law, and I think the problems are as bad or worse than they have ever been. Any disclosure statement to begin with never covers all the possibilities. It serves as a way for unscrupulous people to just simply have a better guide to get around it. I can't believe that more disclosures could even come close to being a solution. I think we ought to just prevent these things from happening to begin with.

MR. FOX: I agree with you. In a transaction to purchase or to sell a home there are so many documents now, there are over 50 documents that the people look at. You just slip in another document, and I don't think it has any impact.

ASSEMBLYMAN STIRLING: I didn't bring up disclosure, I don't know how we got off on that. There are other things to do besides disclosure. The arms length escrow is a good one. The bonding that the District Attorney this morning recommended, both sides seeing the other side's financial statement especially as to the seller because he is now going to assume a liability based on the financial strength of that buyer.

MR. FOX: Of course, sellers can ask for that, if they want to. That's part of the condition of the sale.

ASSEMBLYMAN STIRLING: The Department of Real Estate's job is to regulate in the public interest. Do you see a problem in terms of the secondary or the creative financing? If so, has it manifested itself in complaints against your licensees and what have you done about it, and what do you propose to do about it?

MR. FOX: Okay, yes. There are problems in creative financing, and we have increased our scrutiny of the activities of the licensees to make sure there is still disclosure of...

ASSEMBLYMAN STIRLING: Have you gotten increased complaints against your licensees?

MR. FOX: We have had an increase in the number of complaints over the last two years.

ASSEMBLYMAN STIRLING: Are they stemming from creative financing and failure to disclosure?

MR. FOX: Some of them are stemming from that, yes. We have brought more actions against licensees to revoke licenses because they didn't disclose the terms or the impact of the creative financing elements in the transaction. However it's not what I would call any kind of a epidemic. It is an increased problem and we are giving it more emphasis.

ASSEMBLYMAN STIRLING: Do you agree that it's only the tip of the iceberg now and as the ballons start coming due in the next three years, that this will mushroom into a serious problem?

MR. FOX: I agree with that if those three assumptions don't come to pass. If we have lower interest rates, continued high inflation, housing prices and people's income go up, then they can refinance and we won't have the foreclosures, but if all of those three don't come true, I agree that there will be a problem. I look at it as people buying a house on their creative financing terms today with a two or three year balloon and negative amortization. What they're really buying are trust deed time bombs that are going to go off in two or three, four years, and there will be, I think, a substantial increase in foreclosures. The members of the public will suffer severely that are caught in that squeeze. Unless there are new mortgage instruments available that they can use for refinancing.

ASSEMBLYMAN STIRLING: The question is in looking at your testimony here, it is basically a review of creative financing and what the problems are, but I'm specifically interested in what you propose as a preemptive or first-aid as was brought up here? What can we do instead of waiting around for this to blow up in our faces to preempt it from becoming a problem from your agency?

MR. FOX: Okay. One recommendation that we have, the Department of Real Estate has responsibilities for issuing the right report, the public report, which allows the sale of the newly subdivided dwelling units, and in the Atlas Mortgage case, which turned out to be a fraud, Atlas is now in receivership, we had to issue a public report disclosing that the financing arrangements that they were going to use for the sale of the homes put the buyer at a severe disadvantage, but we did not have the authority to withhold our approval because of this creative financing scheme which was obviously going to be potentially very detrimental to the buyers. One of our proposals for your consideration is giving the Department of Real Estate the authority to review the creative financing package that goes along with the new subdivision. We could come in and deny approval of the financing package, if we feel that it is in fact not in the public interest.

ASSEMBLYMAN STIRLING: Couldn't you just have the Department of Corporations or Franchise Tax go after them?

MR. FOX: You mean after the sak? No, not really. It's not illegal. What they're doing is not illegal. They were giving home buyers a high-risk gamble. What Atlas said, in effect, is we're going to create a trust deed mortgage on the home which will cost you a $500 a month payment for two years, but after that you're on your own. The reality is in the third year the payment instead of being $500 went up to $1,170 in today's market, which would wipe out most of the home buyers, and the negative amortization was $12,000. So they would owe $12,000 more two years later than what they started with. So if we had the authority to review the financing and say, "That's not an acceptable financing package. We won't approve this for sale to the public," I think that would be very helpful. Of course, that only goes for new construction.

ASSEMBLYMAN COSTA: But the majority of the problem here in terms of the creative financing is on existing transfers?

MR. FOX: Yes, 85 percent of the home sales in California are for existing homes and what I'm talking about would only effect the 15 percent. The existing homes is the larger problem. There are, for example, in existing homes, there are transactions that are taking place today which are called cash-to-buyer kinds of transactions, which I think need to be much more regulated than they are now. This is a situation where the buyer makes a deal with the seller where a new loan is taken out by the seller and the buyer gets a substantial amount of cash out of the new loan; $20,000, $30,000, $40,000, $50,000 and the seller takes back a large second trust deed, maybe a $100,000 or 60, 70, 80 percent of the value of the property. The reality is that when the transaction is consummated, the buyer has bought the house with no cash down. He gets $20,000, $30,000, $40,000 in cash and walks away from the house. The seller is left with this huge new loan plus what's owed him by the buyer. These cash-to-buyer transactions are quite dangerous. It's not a major problem. It doesn't happen that often, but to the extent that this is going one, I think we need some regulations prohibiting that kind of transaction.

ASSEMBLYMAN COSTA: As head of the Department of Real Estate and the issuer of the license to those brokers that make probably 70 or 75 percent of those transfers of sales, I understand that it's 20 percent today of transactions between two individuals.

MR. FOX: Yes, approximately.

ASSEMBLYMAN COSTA: Twenty to 25 percent, so 70 to 75 percent of these people are licensed through your office to make these transfers of sale. What can you do to prevent that from occurring under the sanction of the license that you issue them?

MR. FOX: Well there again full disclosure is one aspect for the seller...

ASSEMBLYMAN COSTA: Full disclosure doesn't really amount to a lot.

MR. FOX: The other possibility on the cash-to-buyer is some sort of legislation that restricts the sale of the home to a transaction that reflects the fair market value of the home without an inflated value, without new loans that are beyond the actual value of the home. This is not a major problem. It's one of the aspects of creative financing, but I don't think you have this kind of a transaction in more than one half of one percent of the home sales.

CHAIRMAN BOSCO: You mean on your testimony, though one witness suggested that it was much more than that. Now there's a book out by Robert G. Allen that advocates this type financing, and maybe that will increase the number.

MR. FOX: Yes, it's possible, although people, real estate agents that have gone to the seminars on no-cash-down transactions, when they try to put those transactions together they take it to another broker. On behalf of the seller, we often get a call to the seller's broker asking us, "Is this legitimate? Is it legal? What are our responsibilities in terms of disclosure?" Our experience mostly has been that the agents for the sellers are being responsible about making sure their seller fully understands what is going on.

However, I don't know what the future holds, because there are these seminars, and obviously it sounds good to buy with no cash down. I don't think it happens that often in reality.

ASSEMBLYMAN STIRLING: Well, we have a real disparity of opinion. The prosecuting district attorney from San Diego County indicated he thought intuitively that it was about 10 percent. You say it's half of one percent. Isn't there some responsibility on your part to investigate this or do a sample survey of a thousand transactions, and let us know how it looks?

MR. FOX: We can do it. I'd be glad to do it, whether or not we have the responsibility, sure. If you going to do something anyway, it's better to say you're glad to do it.

ASSEMBLYMAN COSTA: We're glad that your glad to do it.

MR. FOX: Give us about 30 days, we'll provide you with that information.

ASSEMBLYMAN STIRLING: I think that would be very significant. I think it could be providing a real service to the district attorneys and to the public.

MR. FOX: I appreciate the suggestion, and we have a mechanism to do that actually. We have an education and research fund available to fund research projects like that. I'll even ask Professor Rosen for some advice about how to do that, too.

CHAIRMAN BOSCO: Well, unless there are other questions I'd like to move on. We very much appreciate you being here, especially since you had to interrupt your vacation with your family. We have your written testimony.

MR. FOX: If any of the members have any questions in the future, I'll be glad to answer them or respond.

CHAIRMAN BOSCO: Could you give the committee then a summary of your report, findings when you've done that.

MR. FOX: Absolutely. Sure we'll have that done by the end of August.

ASSEMBLYMAN COSTA: Can you contact the various district attorneys and check with them to see what kind of stuff they're getting into?

MR. FOX: Yes, and I have a complaint about the district attorneys by the way.

ASSEMBLYMAN STIRLING: Tell it to Judiciary.

MR. FOX: Okay. Well, I just didn't want you to be too enamored by the testimony. In terms of the criminal aspects of illegal conduct by real estate licensee, they're very slow to prosecute criminally. Wayne Burton, who heads Universal Financial has $100,000 invested in second trust deed investments, has yet to be charged with any criminal violations. Now it's August and his scheme came to light in January. We've already revoked his license, it's already in receivership and the DA's office hasn't done anything.

ASSEMBLYMAN MCALISTER: What county is that?

MR. FOX: It's in San Bernardino County. And I think that that invites people who are interested in violating the law to go ahead and make $50,000,000 and take a chance to fight it later criminally. Thank you very much.

ASSEMBLYMAN COSTA: There was some mention prior to your arrival of the problems with the mortgage loan brokers strike force.

MR. FOX: Yes.

ASSEMBLYMAN COSTA: You might want to indicate that you are involved in this.

MR. FOX: Sure. We, the Business and Transportation and Housing Agency has established a second trust deed mortgage strike force.

ASSEMBLYMAN ROBINSON: I don't see what you're getting out.

MR. FOX: Well we're coordinating our investigative efforts with the Department of Corporations, Savings and Loans, Banks, and receiving additional investigative help from other state departments. The strike force has 43 cases under investigation with $100,000,000 invested in second trust deed and third trust deed schemes. To date, this year, the Department of Real Estate, as well as Department of Corporations, has filed cases with over $250,000,000 at risk from over 10,000 investors. That's on the investors' side, and I understand the focus of this committee is protection for the borrower. However the source of funds for the borrower often comes from these investments, so we have been very active prosecuting licensees that are involved in illegal conduct seeking the investors in the trust deeds. That's part of the problem, but I think the function of the committee here is on the borrowers' side.

CHAIRMAN BOSCO: Thank you, Commissioner.

MR. FOX: Thank you.

CHAIRMAN BOSCO: We will now hear from Mr. Dug Gillies from the California Association of Realtors.

MR. DUG GILLIES: Thank you, Mr. Chairman, gentlemen of the committee. I am Dug Gillies of the California Association of Realtors, and as I think the committee knows our Association represents about 130,000 realtors and other associates who are dealing every day with buyers and sellers who are vitally concerned with the topic that you are examining, the availability or nonavailability of financing for sale and purchase of housing. Almost 600,000 California families last year found that creative financing was essential to the sale or purchase of a home. Therefore, the subject that you are dealing with is a critical one because if anything were done to, in effect, stop creative financing, and I haven't heard anyone here today suggest that it be stopped, it would have prevented those 300,000 transactions involving 300,000 sellers; 300,000 buyers. These people had a need to sell or buy, and generally could not have done so through conventional financing channels, either because money was simply not available or because it cost so much it was out of reach for them. Special fiscal solutions are not limited to housing, of course. After Prop 13, government has spent quite a bit of time in creative financing to finance the needs of government itself. Mr. Costa has a bill this year on benefit assessment districts, which is a kind of creative financing device for government.

ASSEMBLYMAN COSTA: It's been called other things.

MR. GILLIES: Creative financing in housing would seem to encompass any innovative device, whether a loan or not, which makes possible a provision of funds to facilitate the transfer of residential property used generally when conventional methods of financing are unavailable or unattractive. The list would include: installment land sale contracts, which have been mentioned here today; lease with option to purchase; land lease with a sale of improvements; or seller take-back financing through a junior deed of trust. Let me stop at that point to say that each of the four that I have mentioned earlier do not involve a loan. Seller take-back financing is not a loan. Mr. Papan was inquiring quite a bit about usury this morning. The ursury law never applied, never applied to seller take-back financing. The courts have been very clear on that. That is a credit sale, an installment sale if you will, and it is the terms of the sale, that are involved. The parties may adjust the sale price upward or downward in exchange for some term in the financing agreement. You can not therefore isolate seller take-back financing as one item without analyzing the entire agreement and the entire sale and what the interrelationship of those factors might be.

ASSEMBLYMAN ROBINSON: Mr. Gillies would you define how you're using "all-inclusive deed of trust."

MR. GILLIES: Some all-inclusive deeds of trust are written by institutional lenders and others are written by sellers. Where they are written by sellers, the terms of the all-inclusive also might be varied in connection with some change in the price or some other factor.

ASSEMBLYMAN ROBINSON: It has been suggested that severe restrictions be put on all-inclusive deeds of trust and that land sales contracts be abolished.

MR. GILLIES: Well on the land sale contract, if they were to be abolished, and let me say, the witness this morning who referred to them in terms of horror may have looked at some cases where there were great difficulties. I assure you that there have been cases, particularly in recent years, since normally the deed is conveyed to a trustee, where title insurance is granted on the transaction and so forth, where they do not present these risks. At the same time, installment and land sale contracts have frequently been used for the purchase of housing by buyers with no down payments who couldn't have afforded housing in any other way. A lot of run down old property, for example, has been transferred on installment land sale contracts because the seller wasn't willing to convey legal title with nothing down.

ASSEMBLYMAN ROBINSON: I'm not a lawyer, but I've heard a lot of lawyers in my short tenure in this legislature, constituent types, friends and colleagues, tell me that the land sale contract is horrible for both parties and that the uncertainty is tremendous for both parties.

MR. GILLIES: Half the lawyers in the state are wrong every day. I can show you...

ASSEMBLYMAN ROBINSON: Does that include the Justice of the Supreme Court that decided Wellenkamp?

ASSEMBLYMAN COSTA: That half was right.

ASSEMBLYMAN ROBINSON: Now that was six to one.

MR. GILLIES: Professor Hetland, School of Law at Berkeley, the author of the book on financing which was used by the Continuing Education of the Bar, has written very strongly supporting the idea of using an installment land sale contract where coupled with placing the title in trust and...

ASSEMBLYMAN ROBINSON: Recording.

MR. GILLIES: What?

ASSEMBLYMAN ROBINSON: Recording the contract.

MR. GILLIES: Oh yes, yes. So I mean there may be things that could be done to further regulate the use of installment land sale contracts, but their abolition I wouldn't agree with.

ASSEMBLYMAN ROBINSON: All right, would you say the same about all-inclusive deeds of trust.

MR. GILLIES: Yes.

ASSEMBLYMAN ROBINSON: Should there be regulations, should there be requirements, impound accounts?

MR. GILLIES: Yes, certainly in all the literature that I've seen from Real Estate, and by the way, we are doing, and I'm sorry Mr. Stirling stepped out, we are doing an educational job in this area all the time. Having to devise new courses as you pass new bills, but...

ASSEMBLYMAN ROBINSON: Thanks to you we haven't been passing too many.

CHAIRMAN BOSCO: Incidentally not all the bills we pass are done without your approval either. I notice that you sponsor an occasional one.

MR. GILLIES: Yes, sir, and I'll be referring to some of those where we've attempted to deal with some of these problems. But everything that I've seen that our organization puts out has been proposed with respect to an all-inclusive or wrap that there be some institutional servicer and things of that nature. That's part of the package. Maybe that should be in the law. We'd like to examine that and get back to you.

ASSEMBLYMAN ROBINSON: Would that include an independent escrow?

MR. GILLIES: Well, let me get to the independent escrow when Mr. Stirling comes back because he asked me to respond to that specifically, but it's possible that some of this should be in the law. As I might indicate to you, we've got a study going on and hope to come to you in January with some proposals for law in these areas, and this very well could be one.

Some of these instruments, are junior trust deeds that are taken back by the seller; other junior trust deeds are originated by sellers and discounted and sold to investors; junior trust deeds originated by banks; some of the S & L's are heavily in the second trust deed business now; a lot of institutional seconds, some originated through mortgage loan brokers and other; and another, the so called bullet loan, which is the three or five year loan with a 30 year amortization being written by large institutional lenders; buy-down loans that were referred to by one of the witnesses this morning, which are the only things that are enabling builders to unload some of their inventory, which is a very essential thing; and shared appreciation mortgages, which Mr. Costa is working on; and investor participation and down payment in exchange for a share in equity appreciation -- these are some of what we would call creative financing in the market place today.

ASSEMBLYMAN COSTA: Mr. Gillies, I think we all agree that creative financing is in part some of the only means of financing transfers of sale in today's tight money market. And I think all of us agree that no one wants to throw the baby out with the bath water. That certainly is not my intention as Chairman of the Housing Committee, or I think the intention of any of the members of this committee. I think what we would really like to explore with you is what do you really see are the potential problems. I mean we dealt with the lien sale contract about two years ago. I remember when we had some of the over-zealots getting people in situations involving their houses that they shouldn't have been in in terms of home improvement type programs.

MR. GILLIES: I wouldn't put those in a category of creative financing.

ASSEMBLYMAN COSTA: No, no I don't mean that.

MR. GILLIES: That's equity financing.

ASSEMBLYMAN COSTA: I know, but I used the example because some people at that time indicated, "Oh, we ought to do away with the lien sale contract." The lien sale contract is a very valuable tool and I'd never suggest that we should do away with that. Just like creative financing in terms of this situation and sometimes is the only way of providing some financing. What we're interested, I think, in hearing from the realtors is, what do you think are the specific problems in dealing in today's tight money market with transfers of sales where second, third and fourth deeds of trust are used, when the financial arrangements are made in which there's no equity left within the house, in which the only course of today's current alternatives is simply buyer and seller beware. Do you think, furthermore, that we are going to have the problems next year when the balloons come due on the principal on these arrangements that were made two and three years ago, and what should we do about that? These are the same questions I'm asking you that we asked everybody else here today in terms of what are the corrective actions that can be taken, not only prospectively, but how wide do you believe the problem is going to be next year when these, in fact, become due.

MR. GILLIES: Let me talk about that, I would like to get into a survey we've done which I think will answer many of the questions of the committee as to what's going on out there. There was some guesses by the San Diego District Attorney. There were some guesses by other people based on cocktail party conversations apparently. We have some hard data for you which I think it will be of interest to you, and we are prepared to present it. But let me respond first to your question about what's going to happen two years from now, a year from now and so on. Let me say first that there is going to be a problem if there isn't going to be take-out financing at reasonable prices. That problem is not created only by seller take-back second deeds of trust. That problem is created by bullet loans. When you compare a second deed of trust taken back by a seller for $30,000 with a bullet loan written by World Savings for $95,000 as a first deed of trust with a three year due date, your talking in magnitude about a much greater problem created by institutional lenders, but it won't be a problem with take-out financing and the second won't be a problem with take-out financing, and let me add to that, that when you authorize an adjustable rate mortgage, without any cap on payments, without any cap on interest rates, without any cap on negative amortization and if interest rates go up five percent in five years or three years, and some of these are extremely volatile, you are going to have the same kind of problem with that borrower that you have with the borrower of the balloon, only it can occur faster. With the balloon, he knows it's five years from now or whatever it is and he can plan for it, but with an uncapped ARM, and I'm not saying I'm against an uncapped ARM, but I'm just saying...

ASSEMBLYMAN ROBINSON: That's a good point Mr. Gillies. Were there bullet loans before the Wellenkamp decision? Aren't bullet loans...

MR. GILLIES: Practically none.

ASSEMBLYMAN ROBINSON: ...yeah, bullet loans kind of evolved as the lenders' answer to the inability to predict the market place and the inability to get this legislature to address Wellenkamp. They came up with their own little Canadian roll-over. That's what the effect of it is, isn't that true?

MR. GILLIES: Well, I think it...

ASSEMBLYMAN ROBINSON: Well, I don't deny your right. I think there is a real potential for disaster coming from bullet loans.

MR. GILLIES: I think it comes much deeper than that. I think it comes primarily from the volatility in the money market. Let's say we didn't have Wellenkamp, and let's say that interest rates were 17 percent. How many accelerations would occur? Very, very few because very, very few sales would occur, because people couldn't afford to sell and people couldn't afford to buy if they had to go out and finance the whole transaction on a 17 1/2 percent loan. So the sale wouldn't occur. The lender couldn't accelerate, and they couldn't get their money back. The problem is volatility.

ASSEMBLYMAN COSTA: Mr. Gillies, on that point, as a practical matter, if I were a lending institution and interest rates were 17 percent and I could enforce my due on sale clause...I want to do business. If I can't loan money out, then I'm not going to stay in business any length of time. Wouldn't I practically, as some institutions did prior to Wellenkamp, bump the rates up on a gradual basis and give points for income level and credit ratings. I wouldn't refinance the loan at the existing 17 percent, but I might finance it because I know the guy could pay 12 percent, or pay 13 percent. I mean if I were a smart institution and I wanted to stay in business, I know that I couldn't make the damn thing at 17 percent, but I know this guy could probably afford 12 percent and the existing loan was eight percent, and we'd settle some middle ground, where I could make the transfer of sale and refinance the loan.

MR. GILLIES: That's theoretically possible, and it does happen in some cases, but I can give you instances where federally chartered S & L's, which have not until very recently been subject to Wellenkamp or didn't think they were, have still bumped the interest rate to current market at the time of an assumption. Now, understand that under Federal Home Loan Bank Board rules they can't accelerate on a residential owner-occupied one to four, but they can bump the interest to current market.

CHAIRMAN BOSCO: Well, it seems to me that we tend to talk about interest rates on assumable loans as divorced from the percentage of the total loan that the assumable loan is.

MR. GILLIES: Can I get into my survey and I think I can give you some data on that. I have data on that for you.

CHAIRMAN BOSCO: I was going to ask if you had a survey on that, and will be waiting with baited breath to hear your final conclusion on that.

Mr. Gillies has talked against ARM's in three hearings that we've had without ever coming out officially against them.

MR. GILLIES: I have asked you for discretion and may be doing so again Monday when we still have some conversations. Let me talk about ARM for a minute, and let me talk about Professor Rosen's razzle-dazzle graduated payment adjustable rate mortgage. This is being offered or something very close to it by San Diego Federal Savings, and again I'm sorry Mr. Stirling isn't here, but you call up San Diego Federal Savings and say, "I'd like one of those loans." "Well, come around about October maybe we'll have some money to make them." These new instruments are coming out, and we need new instruments. I don't know if we need as many as are coming out, but we need some new instruments. But there is no money. Great Western's got, you know, a new instrument, but they only make the loans to their old established customers. The new couple who wants to buy a home, can't get one of those loans. The new couple who wants to buy a home, interestingly, our survey will show you that of the transactions that we reviewed, about 26 or 27 percent were for first time home buyers in 1980. They are still getting into the market. How? Assumed loans. Creative financing. These new instruments must be combined with some source of money. Now, I'm not going to deny that there aren't going to be some problems a year or two years from now if there isn't some new source of money. But the magnitude of that problem I don't think can be perceived right now.

ASSEMBLYMAN COSTA: Mr. Gillies do you agree with some of the other statements that were made about the lack of priorities that capital investment has in the area of housing by this administration?

MR. GILLIES: Why I'm not sure that I'm totally competent to comment on that. I've read commentary that seems to point in that direction, but I am not an expert in that area.

ASSEMBLYMAN COSTA: Because it leads to the point that you're mentioning, that is there is no new money available. It's going to be a problem and obviously we're concerned about attracting new money for housing, so that hopefully that this won't be a problem.

MR. GILLIES: Well, some source of money for housing has to be found. I am convinced that even the federal government, even this administration cannot turn it's back on that problem if it grows. And it isn't going to grow any more in California than it does anywhere else in the United States. Lenders with Wellenkamp or without Wellenkamp...

ASSEMBLYMAN COSTA: But, you don't think the demand for housing here is greater given the people that continue to come to California and the increased population.

MR. GILLIES: I would like to ask Mr. Singer, our chief economist to come up. He may be able to assist in answering questions on this survey as well. Joel Singer, the Director of our Economic and Research Division and the gentleman who supervised at least the preparation of this survey, but who may be able to answer your questions as to whether housing demand increases at a greater rate here than it does elsewhere.

MR. JOEL SINGER: Well, certainly as some of the other economists who were up here suggested, one of the best evidences for demand looking backwards has been the extraordinary price rise in California. As we look at demand factors we see them somewhat in excess of 300,000 units per year. We know construction is averaging less than half that.

ASSEMBLYMAN COSTA: You would agree with HCD's report of housing.

MR. SINGER: I would. A personal opinion Mr. Costa, I would tend to agree yes, that housing demand in California is greater than the United States as a whole.

ASSEMBLYMAN COSTA: Do you know what the average cost of a home was in California in 1973?

MR. SINGER: I could check it back for you, a rough estimate about $33,000.

ASSEMBLYMAN COSTA: Thirty-nine, I think.

MR. SINGER: Thirty-nine.

ASSEMBLYMAN COSTA: Do you know what the national average was?

MR. SINGER: It was about $2,000 less at that time.

ASSEMBLYMAN COSTA: That's about right. Do you know what the difference was seven years later?

MR. SINGER: We're looking at a difference of about $45,000 currently between California and the national average.

ASSEMBLYMAN COSTA: What are the factors which increased our cost of housing over 34 percent? I know we're getting away from the other thing, talking about new money. You're talking about dealing with balloon payments and creative financing. We're talking about trying to, as Tony Frank indicated, rearrange the deck chairs on the Titanic. I hope that's not what we're doing. All of these are my concerns as we try to address this issue.

MR. SINGER: Well, certainly looking to California, one would have to start with the assumption that the economy has been much more buoyant than the economy in any other state. The rate of economic growth in California has been on the order of 30 to 40 percent greater than the United States as a whole. Immigration is far higher. Population growth in terms of internal growth is much higher.

Restrictions on development that some of the other economists directed their remarks toward certainly is one of the factors in that price appreciation.

ASSEMBLYMAN ROBINSON: How about Prop 13?

MR. SINGER: Frankly that's one that we haven't assessed as of yet. It would be worthy of some further research, I would admit, but we have not looked at that very specifically.

MR. GILLIES: Let me say first that as this survey reveals there is a high utilization of creative financing. An observation -- we believe that many if not most buyers and sellers, and realtors would prefer a home transfer transaction without creative financing. I mean, the realtor doesn't want to have to run around and try to suggest how this deal can be put together. It's cleaner for him if he can just send a person down to the S & L and get a conventional first that the buyer can afford, everybody walks out with cash, everybody likes it better. But, you know, if you are a passenger on a ship and the ship goes down, you might want a first class life boat, but if there wasn't one there, you're going to get whatever there is. And you're going to ride on it.

CHAIRMAN BOSCO: We just want to be sure the life boats don't have holes in them too.

MR. GILLIES: Even one with a hole in it is better than none at all.

CHAIRMAN BOSCO: That's debatable.

MR. GILLIES: It will keep you going for a little while. I think that's exactly what we've been hearing today. That's a very real fact. One of you mentioned the fact that when a person wants to buy a home, they want to buy a home. They may have to buy a home.

And as a consequence if they can, they're going to buy that home. And they're going to reach out and find the tools that are available for it, whatever financing tools are available for it. And, I think it was you, Mr. Chairman, who mentioned that all forms of disclosure at that point in time may have very little rational impact on the decision once the decision has initially been made to buy. Now, so as I say, we believe that all parties prefer conventionally financed housing transactions. And when conventional financing that people can afford is available, again, creative financing will diminish and fade. It will still exist. It has existed for decades. The instruments that are being used are tried and proven instruments. There's been a lot of experience with them. It is just the volume of these right now that is important. So now let's take a look at the survey each of you have. It's just been completed. It isn't dated. It should have been dated yesterday. First let me say that for 1981 based on six months data the annual rate or number of housing resales in California will be 379,000, down from 465,000 in 1980, and down from the all time high of 605,000 in 1978. That data is not in the report. That's an annual rate based on the first six months.

ASSEMBLYMAN COSTA: So you think it's going to be 379,000.

MR. GILLIES: Based on the first six months experience. That's down from 465,000 resales in 1980 or an all time high of 605,000 in 1978. This means that California homeowners, sellers and buyers, are being sharply inhibited in their traditional housing mobility and in many circumstances in fulfilling their housing needs by external conditions. Obviously one factor is the price of the house. The median home price in California has risen from $71,500 in 1978 to $105,838 in June of 1981. It has leveled off.

ASSEMBLYMAN MCALISTER: What was the '78 figure?

MR. GILLIES: The '78 figure was $71,500. The June '81 figure was $105,800. It has leveled off. June '81 is lower than May '81. This has occurred before. These dips have occurred before. It is only six percent above June 1980, so that the rise in the median price of resale housing in the past year at a rate of six percent, is less than the CPI increase for the same period. Second, and major factor today is, of course, the financing. Interest costs are 50 percent above the historic levels. Now, you have the survey. If, for example, if you look on page four, Table three...

ASSEMBLYMAN ROBINSON: Before we start the survey, Mr. Gillies, one thing I was reading was your paragraphs on methodology. It surprises me that only 15 percent of those sampled chose to return their questionnaire even though you were willing to pay the postage. I did better than that in my district.

MR. GILLIES: You ask easier questions.

ASSEMBLYMAN ROBINSON: I'm not sure that I do.

MR. SINGER: I think the survey return rate was slightly higher than that. There were 30 returns we couldn't use simply because they arrived too late for us to get even this data into hands. Secondly, I'm afraid that also reflects the business success of many of our members and thirdly, it...

ASSEMBLYMAN ROBINSON: You think that the other members just had no transactions during that period?

MR. SINGER: A much more significant proportion of them than I would like to see reported that they simply had no transactions.

ASSEMBLYMAN ROBINSON: And they're not included in that 800 samples that were returned.

MR. SINGER: No. No, there...

ASSEMBLYMAN ROBINSON: In order, statistically though to make some comparison we, I'm not a statistician -- I'm just trying to somehow figure out a way then to interpret this material.

MR. SINGER: Given the population we're dealing with, the 330 ballot response given us, I would have to calculate it, but plus or minus 7.5 percent in terms of the range of each of those percentage figures.

ASSEMBLYMAN COSTA: How much of a return is usually necessary to have a balanced sample?

MR. SINGER: It's not really the return. It's the number of meaningful responses relative to the universe you're dealing with. Assuming the respondent pattern is random. And again we are making that assumption and there's reason to believe...

ASSEMBLYMAN COSTA: How did you determine your randomness?

MR. SINGER: Well, we selected at random first. We pulled approximately 2100 realtor members and associate members, we pulled them out every 30th number so to speak.

ASSEMBLYMAN ROBINSON: Is this geographical area...

MR. SINGER: Yes, that was one of the factors because our membership list is based on geography as well. But, one of the reasons we can say it's fairly random, it correlates to much of the information we have. The median price in our sample is $102,000; the median price Dug just reported to you is $105,000. If you look at square footage that links up with many other surveys. We look at the bedroom sizes and so on, the age of the rooms, and so on. It seems to work like a fairly random sample given other information known to us.

ASSEMBLYMAN COSTA: The control factors seem to follow along, a distinct pattern in other words...

MR. SINGER: Yes, it's close. I'd like to see, of course, a higher return and this was to a degree a pilot survey and we may go back and ask for higher return or may work with an independent institution in going for a larger sample, but I am very pleased with what I see the accuracy...

ASSEMBLYMAN COSTA: At a later date I would like to discuss this...

CHAIRMAN BOSCO: Why don't we just stipulate that it is a little above the cocktail party chit chat that Mr....

ASSEMBLYMAN ROBINSON: Mr. Gillies, you can take the mike for this one, this question's loaded. Was the letter that accompanied the questionnaire soliciting responses in order to enable you to kill the Wellenkamp repeal bill currently before the legislature. Or was any other type of dialogue, rhetoric, fact or fancy used to encourage a response.

MR. GILLIES: I never saw the letter. I had nothing to do with drafting the letter. I did see the survey before it went out because Mr. Singer sent it to me to indicate whether I had any input on aspects of it. The purpose of the survey, was frankly, to prepare for what we saw coming. This hearing had not been called at the time. We...

ASSEMBLYMAN ROBINSON: No, I wasn't referring to this hearing. I was referring to the thousands of letters each one of us received as a result of all kinds of mailings going on.

MR. GILLIES: It wasn't realted to those letters, but let Mr. Singer discuss the letter itself.

MR. SINGER: I did draft that letter.

ASSEMBLYMAN ROBINSON: You have to understand, Mr. Singer, we are all politicians, we know how to skew...

MR. SINGER: I thought that was only my Assemblyman. I will be delighted to show you the letter. Perhaps I could read a couple of sentences from it. There was no attempt to relate it to any particular legislation. That's, of course, not to say that our members are not aware of what's going on in the Legislature. But what we suggested here is that we were conducting research according to the types of financing being employed to facilitate the sales of residential properties in today's tight mortgage credit market. With mortgage interest rates generally exceeding 15 percent and the withdrawal from the market many institutional lenders, the forms of financing are rapidly changing. This research project is designed to document the types and characteristics of financing being used in the resale housing market. This study will examine the extent to which transactions in the current interest rate environment are dependent upon the existence of assumable first mortgage loans, and the availability of other alternative financing arrangements.

CHAIRMAN BOSCO: If there's a question about the letter, why don't we just accept it in the testimony and you give us...

ASSEMBLYMAN ROBINSON: I was going to request that, if we could have the whole package just so we could...

ASSEMBLYMAN MCALISTER: Before we go ahead, you mentioned that in June '81 the median resale price was $105,800 and you gave some other figures and said that was only six percent higher than June of 80 and said it was lower than June...

MR. SINGER: May of '81.

CHAIRMAN BOSCO: Lower than May of -- just a month before. Okay.

MR. GILLIES: There have been some dips, there were some dips in the mid-summer of 1980 for example. We've had occasional dips, but we have reached a plateau to some extent, the rate of increase has leveled off. For example, on page four, Table three you will note that only 23 percent of homes are financed today in the old conventional manner with a down payment and a new unassisted first mortgage loan. And some of these will be bullets and some will be non-institutional firsts taken back by the seller which we will discuss in a moment.

ASSEMBLYMAN COSTA: What distinction do you make between the relative frequency and adjusted frequency?

MR. GILLIES: The adjusted frequency eliminates the all cash and the miscellaneous at the bottom and you just redistribute 100 percent on those which involve mortgages.

CHAIRMAN BOSCO: I'm going to have to ask you, Mr. Gillies, to really drastically summarize this. We have it before us, but we have other witnesses and I do want to bring the meeting to a close.

MR. GILLIES: Well, sir, this same table shows that 70 percent of all sales required creative financing and most of these involve assumptions. In other words the depressed level on sales which I have alluded to earlier would be materially further depressed without creative financing. This would be of obvious concern to our membership but would be a critical concern to home buyers and home sellers. Page five illustrates convincingly that creative financing typically is an assumed first plus a second and it produces dramatic savings for the borrower. Look right following Table four where it's indicated that the combination factor here produces the equivalent of 12.57 percent interest rate on a conventional 30 year loan. That contrasts with 15, 16 plus interest rate offered on conventional firsts if the borrower had to go out and finance the entire transaction that way. Now understand that most of these, of course, involve balloons. And that, therefore, the interest factor won't change after the second has matured or the third has matured.

ASSEMBLYMAN COSTA: What is the standard practice among the professional realtors statewide in conducting such a transfer of sale when you issue a second or third that has a balloon on it when you are talking to the seller in those circumstances? Obviously we know the disclosures and the contract, we all talked about how sometimes meaningless disclosure...What do you say when you got this balloon at the end of three years that you're going to have to pay, and you're going to have to pay it at whatever conventional financing is?

MR. GILLIES: You are going to have to pay it and generally speaking the party would require some takeout financing or could in some circumstances go out and acquire another second in the institutional market or from another private investor.

ASSEMBLYMAN COSTA: What I'm driving at is, is it a concern of your statewide organization that the realtors try to make as clear as possible the conventional financing? I mean to say, hopefully interest rates will come down, but there is no guarantee that they will.

MR. GILLIES: Absolutely. That would be a basic disclosure you would have an obligation to make. It is one of the most material facts of the transaction. Under the law, under the ethics of the industry, and under the ethics of our association, that disclosure would have to be made.

ASSEMBLYMAN COSTA: Your realtors, your group are telling buyer beware.

MR. GILLIES: You say, "Buyer this is the situation. At the end of three years, or at the end of five years you're going to owe 'X' dollars on this loan. And you have to come up with that cash or refinance it." Certainly a very material factor in the transaction.

ASSEMBLYMAN MCALISTER: Mr. Gillies, this morning we heard from Mr. Fohrman, the attorney from Riverside. He gave us some examples of, I guess you'd call some kind of a pyramid situation where there were several deals all pending, all dependent upon the secondary financing, creative financing, and he believed that if anyone of these collapsed at some point, that the whole house of cards would collapse. Do you think his concern is justified? Is he over doing it?

MR. GILLIES: I found it difficult to put the gentleman's testimony in context. He testified, for example, that of 150 deals that went through escrow, they were all on wraparounds. That is contrary to all evidence any place. It must be the most unique situation in the world, if that occurred. Reading his article in the real property section of the State Bar publication to which he alluded -- and I hope you all read it, it's kind of amusing -- it's based on conversation that he primarily gathered at cocktail parties from talking to doctors who were interested in financing this, that and the other thing. Dr. Filante had the best answer to that one. If you start asking him about a medical problem, he says, "Oh fine, take off your clothes and I'll examine you." But, it is obvious that there can be situations where a person is both a seller taking back a second and then going into another property and utilizing a second as a means of purchasing. It is conceivable that in some circumstances a pyramid effect could be created. I think it's over done. We've seen certainly no evidence of it yet, as I've indicated to you creative financing is not new...

ASSEMBLYMAN COSTA: We realize that. But yet in this tight market, if the only way you can sell your home is by offering some sort of credit to your buyer and you're dependent upon receiving that, not because you want to move, but because as you stated and I think as all of us are aware, you're forced to move. You have your job, or something like that, and so you're dependent upon getting them to that next home, financing it, and it seems to me that it's wider spread than maybe...

MR. GILLIES: If you are so capital short that all the money, all the equity that you have available in the first home must be used to get into the second home, you're not going to be able to take back a second. Now, an approach to that is to originate a second and to discount it in order to put the deal together. There's all kind of combinations. All I can say about the so-called pyramid effect of the gentleman's testimony is we haven't seen it yet. I can't say it won't happen in isolated circumstances. We don't look forward to it, you know, in a huge number of circumstances. It seems to me that some of this cry of doom kind of prediction is like recent statements of another state official with respect to what could happen if you were sprayed by malathion from an airplane. It leads to hysteria. It doesn't contribute.

ASSEMBLYMAN ROBINSON: I think we ought to correct one thing, if my notes are correct, and it is certainly possible they are not. The gentleman, the lawyer from Riverside's testimony was that all of the cases sampled involved creative financing. They were not always all inclusive deeds of trust.

MR. GILLIES: That certainly could be the case although. We have 70 percent creative financing as it shows in this study. The question was asked earlier as to what, how much does the assumable loan contribute to the deal. Can you find that quickly, Joel?

MR. SINGER: Table five will give you an idea what the interest rates are under the various assumption possibilities and you'll see they vary quite dramatically among the different types of assumption and the degree to which the buyer also used a second and a third. In terms of the down payments, I think that was the question as I understood it. In the situation where the loan is assumed with cash to that loan assumption the loan to value ratio was 57 percent. The case where the second was also employed with an assumption the loan to value ratio was 74 percent. In the case where second and third were both applied with an asumption the loans value was 81 percent.

MR. GILLIES: Well, the chairman asked that we move on and unless you have some further questions on this study or want us to pursue it, I will leave it with you for your perusal. I commend it to you. I think it answers many of the questions that were raised today about what's going on out there in the real world. Now, a point...

ASSEMBLYMAN MCALISTER: I have one question here, Mr.

Gillies, about the Table five, "Cash and New First Mortgage Loans 13.5 percent." Now that would suggest that in the real world the interest rates are not as high as we've been quoted.

MR. SINGER: Well, I think the reason for that, Mr. McAlister, is, of course, that 35 percent of those were originated by sellers. And sellers were originating loans at interest rates at about 12 percent, if my memory serves me, whereas institutions were originating them at 14.77%. So the reason that figure looks so low is because you are now having, and this is a very unusual phenomenon in terms of history, that sellers are also getting very heavily involved in the issuance of first trust deeds.

ASSEMBLYMAN MCALISTER: And becoming their own bankers. Their own lenders.

MR. SINGER: To a degree, in this market with a withdrawal of institutional lenders, that is becoming more essential.

ASSEMBLYMAN MCALISTER: So some of them have had commitments, haven't they, from the past too?

MR. SINGER: The average transaction sampled, I would estimate, was about 120 days old at this point. So we're talking about commitments that were written six months ago when the rates were in fact in the high 14/low 15 range. And that's why I'm confident as to the survey reliability.

MR. GILLIES: Just one point that I do want to make and that is that in this survey there were only two transactions in which there was no down payment and no transactions in which there was cash to buyer.

MR. SINGER: If I might comment further on those two. One was a straight, no down payment deal, with no cash to the buyer; the other involved a $10,000 financing price over the actual sales price. So they certainly don't seem to resemble the situations described previously.

ASSEMBLYMAN ROBINSON: But those situations, let's be very straight with each other, those types of situations that are being reported by your members too, to the various D.A.'s are not about to give you those situations in a survey. I mean...

MR. GILLIES: We have learned of these kinds of situations from our members who have...

ASSEMBLYMAN ROBINSON: You don't mean to imply that they don't occur.

MR. GILLIES: They have been complaining about the fact that they have been presented to them as representing sellers and they have been irate about them.

ASSEMBLYMAN ROBINSON: Those individuals that are members, what I'm saying, Dug, those individuals that happen to be your members are not about to report those types of transactions to you on a voluntary questionnaire.

MR. GILLIES: Possibly not, although some of them -- I would hope perhaps that most of the people of those small number in the state who are engaged in this kind of transaction are not our members, but it is conceivable that there are some of them, and frankly I've talked to brokers, and if they think they've really invented a great deal, they're proud to tell you about it. I bet this Mr. Allen, or whoever he is, in San Diego who's peddling this idea thinks it's the greatest thing since dirt. He probably is going out bragging about it. He wouldn't have any hesitation to tell anybody about it. So, our survey does not disclose that activity as being a signficiant activity. Now, you know, your reservations are perhaps warranted, but in any event, let me comment on the situation of a buyer getting a loan out of a transaction. There can be a legitimate reason for that. Even Fannie Mae writes a loan which is a combination rehab purchase loan, where you're purchasing a property and you're going to at the same time rehabilitate that property. In fact, you enter into one long transaction and you get cash in addition to the purchase price which you use for the rehab. So there are some circumstances when a cash to buyer loan arrangement would be appropriate. We are very concerned about this, however, and I promise you that by January we will have some thoughts for you on possible controls, disclosures, whatever it may be in relationship to that part of the problem.

ASSEMBLYMAN COSTA: Mr. Gillies, you responded to, I guess, the first part of my question, and that is that you don't believe that these pitfalls of creative financing will be a problem unless refinancing isn't available or one of those two conditions that we've mentioned, so I guess you've answered that part of the question.

The other part of the question was, if financing isn't available, what do you think we ought to do next year, vis-a-vis a moratorium, if that becomes a problem in terms of the long term, and I know you're going to make recommendations in January, but we'd like you to give us a clue as to what the thinking of your association is as to what you do with those that are already in the problem, and to try to prevent or avoid, in terms of the long term, the others from getting into such a problem.

MR. GILLIES: Well, let me say first that the organization has no position on a moratorium. The question has not been submitted to them. I will see that it is, and I will have a reaction for you on that question. I personally feel that that would have to be dealt with very, very carefully because of the fact that unless there was a proven need for the person to get the loan extension, you are going to have persons taking advantage of this and just not paying their balloon, even thought they have the perfect financial capability to do so, merely to continue a favorable interest rate and use the money to go to Vegas.

ASSEMBLYMAN COSTA: Then you agree with Mr. Robinson for different reasons?

MR. GILLIES: I think you have to approach that very, very cautiously. I think I agree with Mr. Robinson for some of the same reasons as well. But what do people do? There are people everyday who find that they cannot continue to afford the housing they have purchased, some other circumstances occur, they lost their job, divorce, whatever. These circumstances arise all the time. Some of them lead to default. A few lead to foreclosure. Generally what happens is the house is sold, and they seek other housing, in which case they have had the benefit and the use of that home for the term of years which they have occupied it. Whatever they have paid they have paid in lieu of rent, and if there is an equity available at the time they sold it, they will collect that equity and have it for other purposes. It is a harsh fact of life, but it is not one that is unique to the present world and the present situation.

ASSEMBLYMAN COSTA: I have two other questions, and then I'll end my points. One, you and I have discussed in the past the concept of applying the blended rate formula that Fannie Mae is currently using, as it relates to some sort of a compromise or a middle of the road solution between the problems affecting or what were perceived as affecting Wellenkamp in terms of allowing the lending institutions that participate primarily in housing to upgrade their portfolios and to maintain a source of investment capital for housing. I am submitting those amendments into that measure of mine, and would like to understand whether or not you think that's an approach that has some middle ground that we could explore from the standpoint of your association.

MR. GILLIES: Certainly, I would be happy to explore it. We have preliminarily explored it. We would like to see these specific language that you are considering.

ASSEMBLYMAN COSTA: Do you think it's a possible solution?

MR. GILLIES: It has possibilities, yes, sir.

ASSEMBLYMAN COSTA: Do you think your association could possibly support it?

MR. GILLIES: I will certainly ask and have an answer for you by January. Let me say of course, Mr. Costa, as you know there is nothing in the world today that prevents a lender from making that offer to a buyer at the time of the loan transaction.

ASSEMBLYMAN COSTA: I know. We've discussed that.

ASSEMBLYMAN MCALISTER: By making what offer?

MR. GILLIES: He can offer to refinance that property at that time with a blended rate. He can say to the buyer, "I don't have the right to accelerate, but I'd like you to consider this. You can avoid a short term second, you can have a new 30 year loan, a normal loan evaluation with a blended rate."

ASSEMBLYMAN COSTA: What if he's not brought into the transaction?

MR. GILLIES: That lender?

ASSEMBLYMAN COSTA: Yes.

MR. GILLIES: He could advise all his borrowers that if they have anything in mind the offer stands. Some of them have. You know Maurice McAlister -- I think you know him -- of Downey Savings. He has made all kinds of offers to borrowers to get rid of some of his low paying loans in his portfolio. He's a very innovative, imaginative man.

ASSEMBLYMAN MCALISTER: There must be more to this than I understand. If a person can assume at the lower rate, what reason would he have for agreeing to pay more.

MR. GILLIES: Well, if he can get an advance, which makes unnecessary a second, the second might be written at 18 percent, and this way he gets a totally new loan at 12 1/2 or 13 or 13 1/2 percent, whatever the mix dictates. He doesn't have to worry about a balloon. He's got a fully amortized new 30 year loan that meets his needs for purchase. It's attractive to many buyers. As I say, there is nothing to prevent lenders today from offering them, but what Mr. Costa is suggesting I think is that it may be some form of condition of acceleration.

ASSEMBLYMAN COSTA: The final question is do you believe that the implications of the <u>Tucker</u> vs. <u>Lassen</u> case that was cited in terms of its relation to liability...

MR. GILLIES: Oh, no that was <u>Wyatt</u> vs. <u>Union</u>.

ASSEMBLYMAN COSTA: <u>Wyatt</u> vs. <u>Union</u>. What does the association believe the impact or potential implications of that are to realtors who may engage in such transfers or sales only to find that the buyer or the seller seeks litigation as a result of the fact that they were unhappy with the agreement of the contract?

MR. GILLIES: Well, sir, I hope you'll read Wyatt and if you want, when you get up there next week, if you'll call me I'll get you a copy, but I'm sure Mr. Melnicoe can get one for you very easily.

ASSEMBLYMAN COSTA: I'm sure we can get a copy.

MR. GILLIES: The fact situation in Wyatt looks just unbelievably horrible. It was gross. To try to translate that...I think the gentlemen who suggested that it be extended...

ASSEMBLYMAN COSTA: You don't think it's a threat.

MR. GILLIES: Oh, I'm sure somebody's going to be sued. That keeps another industry going, you know. I'm sure there's going to be some suits, and they will revolve I think around the fact situation.

ASSEMBLYMAN COSTA: What do you think really are the responsibilities of the realtor. I know that it was mentioned. Mr. Fox mentioned earlier that you opposed the bonding concept that was proposed and another measure that was up before the legislature.

MR. GILLIES: Yes, and I do want to mention to you by the way, that we have in our industry something which now the bar has, but which real estate had before the bar. We have what we call a Recovery Fund, which is financed from license fees, and if a person has an unsatisfied judgment against a broker for acts arising out of his license, he can recover from the Recovery Fund up to $100,000 against a broker.

ASSEMBLYMAN COSTA: Have there been any recoveries?

MR. GILLIES: Oh, yes. About $200,000 or $300,000 a year are paid out of that fund on such recoveries. And so we have always considered that to be a substitute for bonding. Now I don't know if you want to get into a long discussion on bonding or not.

We are supporting -- Mr. McAlister is amending a bill of his which, I understand, will relate to mortgage loan brokers' activities which, coupled with SB 391 by Senator Watson, will deal with further disclosure to lenders. Mortgage loan brokers are now required to make disclosure to borrowers. This will require disclosure to lenders in rather specific terms. It will deal with appraisals, with credit reports, with credit activity, many other factors. It will limit so called self-dealing, will require annual financial review by a certified public accountant furnished to the department, require certain reporting to the department and deal with mortgage loan brokerage in a number of ways. And we will be in support of that legislation. We are in support of that legislation. So that activity, and those proposals which have arisen from the Atlas case and the Universal case and so forth, hopefully will become law this year.

SB 391 (Watson) is, I presume, pending in this committee. It has passed the Senate. As I mentioned to Mr. Robinson earlier, we in 1967 sponsored a bill, SB 330 by Senator Wilson, to require disclosures by sellers to buyers of a number of conditions relating to the sale. One of those disclosures related to take-back financing and the details of it and the facts about balloons and all this sort of thing. That was bitterly opposed on the Assembly floor on the basis that we were trying to make a transaction so complicated everybody would have to hire a realtor to do it. So we didn't get the bill that year. We reintroduced it in 1979 as AB 932. It came to this committee, and it didn't come out of this committee. So this year we introduced a trimmed down version, AB 888 by Mr. Dave Stirling. It came out of

Judiciary, got on the floor, and in the middle of an explanation just before the roll-call, we found out we didn't have the votes. It's on the inactive file. We can use that bill. We'd be happy to put back the disclosure with respect to take-back financing into that bill as a fourth item. We are getting flack on the floor from some of the members of this committee about that bill being overly complex and the burdens you're putting on people and so on. These are things that have to be weighed. We think that the areas of appraisal, the areas of loan evaluation, the areas of credit data, and many others which were mentioned here today, and I can furnish the committee with a list and read it to you now if you want, should be examined, but they have to be weighed carefully. They would not, in our judgment, eliminate creative financing. We believe that some of them can be written in a way to increase consumer protection without placing undue burdens.

Mr. Stirling asked and Mr. Robinson asked earlier, and both of them are not here about the independent escrow aspect of the thing.

ASSEMBLYMAN COSTA: The arms length provision?

MR. GILLIES: Yes. The problem with that is that the District Attorney of San Diego County hasn't read the Escrow Law or if he has he hasn't understood the Escrow Law, because if you read the definition of an escrow, in that law, every item goes into a realtor's trust account -- I take a deposit from you and I put it in -- instead into my pocket or in my own bank account -- I'm precluded from doing that by the law. I must put it in a trust account, and then it will go to escrow eventually when an escrow is opened. But everyone of those is an escrow as defined under the Escrow Law. So

So we would have to funnel all, you know, all our things through escrow with the costs involved and who's going to pay for those? The customer. So you'd have to rewrite the definition and no one has ever suggested -- this proposal has been made before, bills have been introduced to do it before. No one has ever suggested what that appropriate new definition would be. We believe that broker held escrows can save customers money in some circumstances. Recently, not too recently now, it's a few years ago, a study by Cal State Fullerton, indicated that less than three percent of escrows are held by brokers, however, under their exemptions.

CHAIRMAN BOSCO: Can we continue then after the...

MR. GILLIES: Well, Mr. Chairman, I don't want to take more time. I say to you, I pledge to you that the intent of our association, we have in addition to securing the background material which has been presented to you today and it's the same survey, is the first step to find out what is going on out there. We have a committee and a staff function ongoing to examine the allegations of problems in the area of creative financing with the intent of producing recommendations for legislation in this area.

ASSEMBLYMAN COSTA: Maybe I could carry some of the concerns.

MR. GILLIES: Very well could, sir.

ASSEMBLYMAN COSTA: Love to carry a realtors bill.

MR. GILLIES: We'd be delighted to talk to you about that sir.

CHAIRMAN BOSCO: All right. Thank you.

MR. GILLIES: Mr. Chairman, I want to say to you that while buyers and sellers and brokers would probably prefer not to use it, and while there may be some difficulties with it, if we didn't have creative financing, there would be an awful lot of people in this state who would not be able to deal in their residential property as they must, and until adequate conventional institutional financing comes back into the market place, creative financing must not only be sustained, it must be encouraged.

ASSEMBLYMAN MCALISTER: Now what will the situation be? Starting very soon we very likely are going to have mostly variable or renegotiable or fluctuating rates.

MR. GILLIES: I would think that's correct, sir.

ASSEMBLYMAN MCALISTER: ...and so aren't we in a different ballpark then?

MR. GILLIES: Yes, sir. You'll recall that in the discussions of the parity bills, for example, there were discussions of sunset on the authority of the regulators to adopt these regulations with the thought that the Legislature should re-examine that situation at the end of three years. That sunset is in place in AB 650. It is my understanding that Senator Foran is going to amend it into SB 809 and hopefully in two and a half years, two years, three years when you look at this again because of that sunset provision we will be able to have a more stabilized climate and be able to more perceptively deal with the issue.

ASSEMBLYMAN MCALISTER: In theory that will lead to a more stable market. It will presumably lead to somewhat lower rates going in. It has the potential for some volatility as you pointed out, and it makes some of us nervous.

MR. GILLIES: Yes, no question about it, and you know Freddie Mae authorized some instruments along about the end of May. I have seen data on the first two auctions that they had for those adjustable rate mortgages. In the first one nationwide they sold $900,000 worth of commitments for mortgages. That's a drop in the bucket. The second one, $700,000 worth of mortgages...

ASSEMBLYMAN MCALISTER: These are variable?

MR. GILLIES: These are the new adjustable rate mortgages. They wanted 16 percent, which isn't saving a lot of money for the advantages the lender gets. So I don't know whether these are going to be acceptable in the market place. Only time will tell that.

ASSEMBLYMAN MCALISTER: Well, if it's at 16 percent, I suspect they'll have some difficulties.

MR. GILLIES: That's an initial rate of 16, and the interest rate can move up coupled with, in that case, a contract rate index without any cap on upward interest movement. It's scary, but that's the only world we're living in right now, and that's why the sunset is so vital on the parity legislation.

ASSEMBLYMAN MCALISTER: Has your organization taken its position yet on AB 650?

MR. GILLIES: They're still trying to get a few little amendments here.

ASSEMBLYMAN MCALISTER: Trying to get a few little amendments. All right. Thank you, Mr. Gillies.

MR. GILLIES: Thank you.

CHAIRMAN BOSCO: Our next witness will be Robert L. Kemper, the Vice Chairman of the Board of Wells Fargo Bank. Mr. Kemper, welcome back. I think you've testified before at one of our hearings.

MR. ROBERT L. KEMPER: Thank you. In the interest of time Mr. Chairman, Mr. Welborn and I will do this together. We both have copies of our testimony and we will try to summarize the key points in just a couple of minutes in the interest of your time.

First of all, I'd like to congratulate the committee for looking into this matter because we do believe that the kind of creative financing that's been discussed today is a problem. It's going to be more of a problem as some of these loans come due, and as Mr. Maisel said we don't believe that the interest rates are going to be substantially lower in the very near term, and so they are going to be a problem.

Creative financing has been accelerated by a couple of factors: (1) high interest rates; and (2) the Wellenkamp decision, which repealed the due on sale clause. There's no more concern that anyone should have than the protection of the consumer be the borrower, seller or private individual who is investing in junior liens. We feel there's a large difference between the consumer's safeguards that are provided in a well structured lending industry and the high risk environment of creative financing.

Home mortgage transactions in the traditional market place, that is that provided by banks, savings and loans, and mortgage bankers, are surrounded by a multitude of federal and state laws and regulations. And I'd just like to cite two of those that helped to protect against some of the things we've been talking about. One is the concern over the borrower's ability to pay, and you've heard some situations of the kinds of problems people get into because of their inability to handle the mortgages that they have taken on. Study by one of our members shows that the average delinquency rate for loans assumed without the review and approval of the lending institution is more than double that of loans assumed with the credit approval of the bank.

A second such type of protection is that in the traditional market the lenders operate under laws that require the lender to provide a good faith estimate of all costs relevant to the real estate transaction. So all parties or the borrower knows going in exactly what is going on. I think in some ways the point we're trying to make is that in the traditional regulated markets that we've had the consumer has had protection. Due to high interest rates and the lack of ability for people to qualify for those rates, people have looked to creative financing, and that in itself creates a problem. If someone cannot qualify for conventional financing, the odds are that if you go to creative financing, particularly in some of the types of situations that have been discussed today, you do find that people are in over their heads and you are counting on lower rates in the future inflation in the price of the house to bail them out. And if those things do come true, fine. If they don't, we believe you're going to have problems. So basically, we feel that the problem of creative financing has been and is caused by high interest rates and also the fact that under the Wellenkamp decision lenders do not have the right to approve these transactions or look at them before they're assumed.

And now Mr. Welborn would like to give you a few facts on some of the things that they've seen.

MR. MICHAEL WELBORN: I will try and be equally brief. I'm Mike Welborn, Vice President of Government Affairs at Crocker Bank and with me is Jim Hawkins, who manages our Home Products area, formerly responsible for Crocker's residential real estate area.

In my testimony you'll find that we conducted, we tried to gather our own data on what's going on in creative financing, so that we could draw some conclusions from it to present to you as opposed to coming here with hypotheticals. What we did was survey our entire branch system, our 375 branches as well as our mortgage company operations. I will anticipate the question Mr. Robinson would ask if he were here, and I will admit that the introductory letter over the questionnaire was probably somewhat biased and that I acknowledged that we would use it in testimony in preparation for this hearing. Our branch managers are certainly well aware of our efforts in support of Mr. Costa's piece of legislation.

I don't think it's really necessary for me to go into the results of that survey because quite frankly some of the stories that were referred to here today are quite frankly worse. There are some tear jerker types of case studies in that testimony, but what has become apparent to me sitting in the back row all day is that the cases we see as a lender are not at all the cases that are really in jeopardy. We get customers coming to us in situations of anguish, frustration, despair, saying, "What can you do to help me salvage this transaction?" Quite frankly, at that point in time there's very little we can do. We are absolutely, totally frustrated by the fact that we are not a party, cannot be a party, and are specifically excluded in escrow instructions to not even be informed of this transaction. We don't find out until the house has changed hands many, many times down the road or there's a problem, a serious problem, and by that time it's too late. In fact, listening to the testimony today, I jotted down these points which are also in my testimony, six areas of abuse that I think are due nearly 100 percent to the lack of presence of a financial institution in the process. There are no new ideas here, but if I might, I'd like to just list those six thoughts.

First is that buyers do not need credit or underwriting qualifications. The second abuse is that the value of the property is not independently evaluated, which often results in a higher price or over-encumbrance. The third abuse is that homes are being sold with little or no equity. Very often there is little interest on the part of the buyer to remain in that property. And we heard tales of the buyer actually getting cash out of the transaction. The fourth area is inadequate consumer protection and disclosure. The buyer is very often relying on the seller to provide disclosure. The seller has an interest in the transaction. The buyer often does not know the proper loan amount. His payments are past due. He relies upon the seller or perhaps the realtor, and they are interested in closing the deal. The fifth area of abuse is that the buyer or the seller are commiting themselves to positions that they would otherwise not commit themselves to if they were aware of the risks. They are unaware of risks and they're taking positions they would not take if they were aware of what's going on. And the final abuse and perhaps the one we least like to see is where there are situations of a more knowledgeable individual taking clear advantage of an individual who is less involved, less knowledgeable with the transaction.

Now it seems to me that those six categories of abuse, and I think that pretty much covers most of the transactions, or most of the stories that have been told today, will not occur or will be significantly reduced if there are financial institutions involved in that transaction in one form or another. Of course the solution that we would prefer to see to get the financial institution involved in that transaction is a repeal of Wellenkamp.

Now I won't go into the other reasons why we think that it's desirable to repeal Wellenkamp, but simply from the creative financing aspect I believe that most of these problems would be eliminated. Now the question may be asked that if we repeal Wellenkamp a lot of these deals won't go through at all. But, I think there are some things we should consider. First of all a good number of these deals that we see just need straightening out. In other words if both parties were fully informed, we're aware of the alternatives, we're aware of how the deal could legitimately be structured, a significant number of the creative financing deals that we see possibly could have been done with conventional financing. The second point is a good number of deals probably shouldn't go through in the first place. A lot of these abuses just shouldn't take place. The deals should not go through. They are clear abuses and they should not happen. We would never let these deals go through as conventional lenders. And the final point is that nobody has really talked about price. The realtors in their testimony said that, as I understood, prices were basically flat. Well, it seems to me that in periodsof tight credit, if the market were operating in a normal fashion, one would expect the price of homes to decline. In fact, in this environment as horrendous as it has been described one would expect the price of homes to decline dramatically. I frankly don't see that as being undesirable. But the prices of homes have not declined. As a matter of fact, creative financing has fueled prices because, as it's been told repeatedly here today, creative financing has a hidden cost, and that cost is added to the price of the home. That's basically the...

CHAIRMAN BOSCO: Mr. Welborn, I want to go back to kind of a theme that I've been asking about all the way through. And that is, Mr. Gillies points out, and I have no doubt that everyone would like to be an intermediary in packaging loans, but, I'm interested in what it actually costs the average person with the assumability of the loan and without. And Mr. Gillies has through his survey, and I supposed we could argue for a long time over the methodology, but nevertheless he has at least postulated that the presence of an assumable loan creates overall about a 12.75 percent interest rate which I'm sure is substantially below what conventional lenders would allow. Do you have any facts to dispute that? I mean I know there's the balloon payment that has to be weighed in, but does your industry have any body of facts that contradicts that, that tells us in numbers exactly where the average consumer is with or without the...

MR. WELBORN: No sir, we don't have any data on that. In fact I couldn't probably dispute that number off the top of my head. That sounds somewhat reasonable, but what I might point out is that the focus of your question is on rates. And there's also a price question as well. In other words the size of the loan times the interest rate is the size of the payments. If the price of the home and the price of the financing were to decline, then borrowers would be able to qualify at significantly higher rates yet making the same monthly payment. So the question really can't just entirely focus on the rate question. I don't dispute that number, but I think it's also extremely important to consider that in the absence of credit the price of homes will decline. That's the way the market has to function. And if the prices of homes are to decline, people will be able to now qualify at higher rates than they otherwise would be able to qualify. So I think that if there's two considerations there, we can't isolate just the rate question from the price question.

CHAIRMAN BOSCO: Are you saying then that my question can't quantified, that you probably never could come up with a formula for answering that.

MR. KEMPER: Oh I think that one of the things that you pointed out was that you are talking about a situation that sometimes is as short as one, two or three years, and if you look at a transaction period that goes beyond that, when you are getting into refinancing, you may find that you're talking about people that can't get the refinancing, which gets into the problem itself.

CHAIRMAN BOSCO: I think the frustration that I have, and I don't know if it's shared by other members of the committee, is that it's always possible to hear horror stories. You could take the most legitimate transaction of all time and over a period of a thousand times that it was repeated you'd have five horror stories. But I don't really feel that I have a good picture for what's happening out there. Some say three year balloon payments, seven year balloon payments, 25 percent interest, 15 points, what you're going to be charging today as opposed to what you're going to be charging a year from now. How do we really make decisions based on that kind of information?

MR. KEMPER: I sympathize with your problem. We are not in a position to give you that kind of information because we don't see that transaction when the loans are assumed. So we can't give you that kind of data.

CHAIRMAN BOSCO: Do we just sort of have to wait till the tidal wave either hits or doesn't hit to know what happened during this period of time?

MR. FRED BIEL: Mr. Chairman, I'm Fred Biel from Lloyd's Bank. I run the Residential Real Estate Department. Earlier this year under a program that was sponsored by Fannie Mae wherein they offered to purchase lender loans if they were put together in the right way, we went into the marketplace on a trial basis seeking to originate or to assist sellers in putting together some creative finance deals where the borrower/buyer of the property would be underwritten by an institution with the eventual intent that the loan could be sold to Fannie Mae to provide further financing at the time the balloon came due or some time when rates did moderate. It was horribly unsuccessful. I think in a 90 day period in certain areas generally spanning the state we created one deal. Most of the events that came up were what we saw. The transactions that we were allowed to see showed, showed and really supported what Mr. Gillies said, that the creative finance market runs around the 12 to 12 3/4 area. And we might say that is the interest rate set by the marketplace. That's what a buyer will pay and that's the least a seller carry back will accept. The marketplace set that rate. To then try to convert that, the seller almost upon application would say, "What would you charge me to buy that loan today? I don't want to own it, I really never wanted to be a lender. How much discount to place it?" And we would tell him what it would cost to take it to the current Fannie Mae yields. In some cases 12, 15, 20 points. That of course came directly out of his equity. And it would become an unacceptable transaction. And that's the reason that program that Fannie Mae put forth has not turned anything worthwhile, and we have since abandoned it.

But, the other point that would then come up on anybody that went the next step and said, "Well, okay I'll do that. I will accept that." In some cases then the buyer would step in and say, "Wait a minute. If I have to be underwritten by a traditional lender, I would have gone to him to start with. I'm not lendable. I have had credit problems. I'm short term on my job, or whatever. And that's one of the reasons I'm in creative finance, because there is no other way for me to buy a home." So you ask for numbers. We're almost blocked out, as they said, because we weren't there to start with, and what little bit we've dabbled with shows us that maybe we didn't want to be there to start with. We think it's a time bomb because we know the deal closed anyway. And that buyer is going to be back to us within a short period of time saying, "Well, I put my $10,000 into the property. The balloon is here. Somebody has to help." And we said, "We told you three years ago we couldn't help."

CHAIRMAN BOSCO: Do you think that it is unlikely that conventional lending institutions will be able to come to people's rescue at that time?

MR. BIEL: We are always seeing people at our door. We have people there as recently as yesterday, making application for loans because the seller carry back was due. And there is no way that a regulated financial institution could originate that loan because of the amount of credit that person needed because of negative amortization on the seller carry back and the other terms that he allowed himself to get into he just wasn't qualified. We would have been imprudent to make that loan.

CHAIRMAN BOSCO: It might be wise to keep track of that information.

ASSEMBLYMAN COSTA: Do you agree with the statement that the practice of some of the financial institutions or lenders of making a bullet loan with a short term balloon is no different than some of the problems we're talking about within creative financing.

MR. HAWKINS: I strongly disagree. Because the...

ASSEMBLYMAN COSTA: Would you like to make the distinctions?

MR. HAWKINS: I would disagree in the respect that when we at Crocker make a short term loan we're looking at a borrowers ability to be able to refinance or rollover that loan at the end of three years, go to other assets. We're basically looking for a bankable deal. We will not extend credit solely based on the value of the property. We're always looking two, three, four, five years down the line for where that source is going to come. So for the most part I think we exercise more discretion and a little tighter underwriting on that type of loan.

ASSEMBLYMAN COSTA: You think there are some very clear distinctions between comparing the two?

MR. BIEL: Oh yes. We require complete application on a borrower. We verify the significant entries on it and then we submit it to normal underwriting criteria and say, "Three years from now you are going to have to do something. What will be your probability to handle that new debt?"

MR. HAWKINS: I'd like to also add that we go to great pains to educate our customer in respect to what will happen three years down the line. We have printed notices where we do go through all of the possible potential impacts, given high rates, more continuing high rates, more disclosure.

CHAIRMAN BOSCO: Well, back to the sinking lifeboat theory, you know there could be an argument made that maybe it's better to give people a little leeway and see what happens. Maybe if you're so prudent in trying to predict what is going to happen three to five years from now, you deny people a very basic necessity, and who knows, maybe if they could package together a loan on perhaps a less prudent basis they may end up making it. People do survive sometimes against great odds, and I haven't ever noticed banks acknowledging that.

MR. HAWKINS: I agree with your statement except for the fact that our standards are set by past experience on what we see as an individual's ability to handle certain levels of credit. And we we use ratios ourselves and I think we're just extrapolating from past experience. As a general statement, would you lend your grandmother's retirement money on this?

CHAIRMAN BOSCO: Maybe that doesn't always have to be the standard though for an average home loan.

ASSEMBLYMAN COSTA: To take the point maybe in a different tact than Doug was trying to make. You don't have the statistics basically about the extent of the problem because for the most part you're excluded from direct involvement in the problem, and I think we understand that. But, what do you think are the similarities in terms of the change of economic climate, change of emphasis on the national level from housing to other areas of investment capital which you participate a lot in? Do you think there are any comparisons here? I come back again to my concern about a source of investment capital for housing. What are the similarities? Some person the other day was trying to make reference to the 1920's and the fact that they quit originating long term loans on residential property, and that we are following a similar pattern. I don't believe necessarily that history always repeats itself, but find it really tough out there to find anybody interested in getting involved in investment capital for housing.

MR. KEMPER: Well, I think that's true and the reason is basically because we have had volatile interest rates. We have had inflation over the past few years. You see the situation of lenders, and it's most visible in the case of the S & L's, but it's equally visible if you look at the earnings records of the major California banks who also are heavily involved in the housing market. To rely on the fact that in the future these things are going to come to pass and we are going to have low interest rates and be able to do that thing is just an enormous gamble. It's been a tremendous problem to those that have been involved in that industry.

And now you have new instruments that take some of that problem away, and you will find that lenders would be willing to be in the mortgage market if people can qualify. But the people can't qualify at the current high rates. And if rates go down we all applaud because we all make more money in a lower rate environment. So we would be delighted, as I said in my testimony. One of the things that's the big problem is high interest rates. High interest rates force people in the housing market to have to pay much more as a percentage of their income than they can really afford to do. That's the problem we have. If you drop the interest rates, not you, but if the interest rates in the country come down to a reasonable level where people can afford the kind of instruments you have, you will see institutional lenders back in the real estate market.

ASSEMBLYMAN COSTA: Do you believe that creative financing has been a factor in the use of low interest loans and artificailly keeping up the cost of housing?

MR. KEMPER: Yes.

ASSEMBLYMAN COSTA: When it maybe would have taken a down turn.

MR. KEMPER: Yes.

ASSEMBLYMAN COSTA: I would like to see some statistical analysis to prove that. I don't know if you can. That's a statement that's been made by a number of folks. We don't have any proof of that.

One final point. The concept back again on the Fannie Mae program on blended rates. If we offered that as I suggested to Mr. Gillies as an option, some sort of a compromise knowing that it's, as Mr. Frank mentioned earlier this morning, not one that's necessarily desirable or attractive to everybody, but it's maybe a means to the end of trying to provide some mortgage capital and upgrade some of these portfolios and get away from some of the abuses of the creative financing because you'd have a new mortgage in effect. Could you support a measure such as that?

MR. KEMPER: First of all, I should have said in the beginning I am speaking today as the President of California Bankers Association. I cannot speak for that association because we have not addressed the issue. We'd be glad to take a look at it.

ASSEMBLYMAN COSTA: Please do.

MR. KEMPER: I think one thing that you have to keep in mind when we look at that is that we are still coming up with a rate situation that is artificially low. And that means that for the home buyer that does not go into the blended rate he is again subsidizing the people that have the blended rate. So I think you know you've got...

ASSEMBLYMAN COSTA: What do you mean by that? Let's back up.

MR. KEMPER: On the kind of rate example that you were using before this morning we were talking about a 12 percent rate, as opposed to putting new money out at whatever the rate is. Although it's better than what you've got now, you still have a lower than the market rates, which means that the new rate in order to provide some kind of profitability to the institution is artificially high to make up for what you've got on the low side.

ASSEMBLYMAN COSTA: Maybe the interest rates will come back to 12 percent next year.

MR. KEMPER: That would be nice.

MR. HAWKINS: Could I ask you a question on...you referred to this proposal a couple of times, and I guess I'm not totally familiar with it. Maybe you can clarify it. Would such a proposal also include a due on sale provision? In other words, if there was not a method of enforceability that we would go through, everyone would either go with this blended rate, if it was to their advantage, so they would be subsidized by the banks on their new money or they would all go "subject to." And then you would have all the creative financing abuses all over again.

ASSEMBLYMAN COSTA: Probably with parity the new mortgage would then have that adjustable factor and the due on sale clause probably wouldn't prospectively be a problem.

MR. HAWKINS: But I thought you were referring to a blended rate for outstanding mortgages. All the mortgage money that's out there now.

ASSEMBLYMAN COSTA: Well, it gives an opportunity to combine the old with a new loan in the form of a wraparound.

CHAIRMAN BOSCO: This would be on new transactions?

MR. HAWKINS: I understand. My question is suppose an individual said, "No we don't want to go that route. In fact, we're still going subject to. We're not even going to tell you." In other words, let's assume we accepted this proposal, and we said, "Fine we are willing to offer it," but customers come to us, and if it's to their advantage they take it and if it's not to their advantage because they're not credit worthy, they don't qualify, or all these other reasons we've listed they don't want to go through a conventional lender and all these abuses occur. If we don't have the teeth to enforce it, if we don't have the due on sale provision, to me, the blended rate isn't really worth very much because you're still going to have all of these creative financing abuses.

ASSEMBLYMAN COSTA: Obviously we'll have to take that under consideration.

CHAIRMAN BOSCO: Thank you gentlemen, very much. Have all of you been given the testimony that you intended? Tomorrow we're going to hear a bill by Mrs. Hughes having to do with the Callie Mae proposal. I want to thank all the people that came to testify. The testimony was excellent and enlightening. I'd also like to thank Charlene Mathias, our consultant, and Pam Cavileer, our secretary, for the job that they did in helping us to set up this hearing and the sergeants who have been so faithful as always. Thank you all very much. We will conclude this hearing.

REAL ESTATE PURCHASE CONTRACT AND RECEIPT FOR DEPOSIT

EXHIBIT No. 1

THIS IS MORE THAN A RECEIPT FOR MONEY. IT IS INTENDED TO BE A LEGALLY BINDING CONTRACT. READ IT CAREFULLY.

Ramona, California ______________, 19____

Received from [redacted] Inc.

herein called Buyer, the sum of Five Hundred and No/100 -------------- Dollars $ 500.00

evidenced by cash ☐, cashier's check ☐, or ______ ☐, personal check ☒ payable to [redacted]

~~XXXXTYXNINEXTHXXXAND NINXXXXXXXXXX~~ to be held uncashed until acceptance of this offer, as deposit on account of purchase price of NINETY NINE THOUSNAD NINE HUNDRED FIFTY AND NO/100 ---- Dollars $ 99,950.00

for the purchase of property, situated in Vista, County of San Diego, California, described as follows: [redacted] Vista, CA

1. Buyer will deposit in escrow with [redacted] Realty Escrow the balance of purchase price as follows:

a) $15,000. cash including above deposit

b) Buyer to assume "subject to" existing Note and Trust Deed in approximate amount of $53,900. payable $510. per month, including 10.25% interest; Seller to credit Buyer with impound account.

c) Buyer to obtain a new 2nd Trust Deed loan not to exceed 75% of appraised value at current market interest rates.

d) Seller to accept a purchase money note and 3rd Trust Deed of $11,050. at 12% interest, payable $110.50 or more per month, all due and payable in 3 years or sooner.

e) Seller to accept a purchase money note and 4th Trust Deed of $20,000; all due and payable in 3 years or sooner.

f) Offer subject to property inspection by Buyer.

Buyer states that [redacted], president of [redacted], is a licensed real estate broker in the state of California.

Set forth above any terms and conditions of a factual nature applicable to this sale, such as financing, prior sale of other property, the matter of structural pest control inspection, repairs and personal property to be included in the sale.

2. Deposit will ☐ will not ☒ be increased by $________ to $________ within ________ days of acceptance of this offer.
3. Buyer does ☐ does not ☒ intend to occupy subject property as his residence.
4. The supplements initialed below are incorporated as part of this agreement. - none

		Other
____ Structural Pest Control Certification Agreement	____ Occupancy Agreement	____
____ Special Studies Zone Disclosure	____ VA Amendment	____
____ Flood Insurance Disclosure	____ FHA Amendment	____

5. Buyer and Seller acknowledge receipt of a copy of this page, which constitutes Page 1 of 2 Pages.

X ______________ BUYER   X ______________ SELLER

X ______________ BUYER   X ______________ SELLER

A REAL ESTATE BROKER IS THE PERSON QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE CONSULT YOUR ATTORNEY.

THIS IS MORE THAN A RECEIPT FOR MONEY. IT IS INTENDED TO BE A LEGALLY BINDING CONTRACT. READ IT CAREFULLY.

[redacted] VISTA, California 6-18, 1987

Received from [redacted]

herein called Buyer, the sum of Five Hundred & no/100 Dollars $ 500.—

evidenced by cash ☐, cashier's check ☐, or ____________ ☐, personal check ☒ payable to ____________

[redacted] ESCROW, to be held uncashed until acceptance of this offer, as deposit on account of purchase price of

SEVENTY-EIGHT THOUSAND FIVE HUNDRED & no/100 Dollars $ 78500.—

for the purchase of property, situated in VISTA, County of SAN DIEGO, California,

described as follows: [redacted]

1. Buyer will deposit in escrow with [redacted] ESCROW the balance of purchase price as follows:

A) $20,000.00 CASH DOWN INCLUDING ABOVE DEPOSIT

B.) BUYER TO ASSUME "SUBJECT TO" EXISTING VA NOTE + TRUST DEED IN APPROX AMOUNT OF $9,500, PAYABLE $ PER MONTH.

C.) BUYER TO OBTAIN A NEW LOAN + 2nd TRUST DEED NOT TO EXCEED 75% OF APPRAISED VALUE AT CURRENT INTEREST RATES.

D.) SELLER TO ACCEPT A PURCHASE MONEY NOTE and TRUST DEED OF $49,000. @ 12% INTEREST PAYABLE $490. PER MONTH OR MORE, ALL DUE + PAYABLE 3 YEARS OR SOONER

E.) THIS OFFER IS SUBJECT TO BUYERS APPROVAL OF STRUCTURAL PEST CONTROL REPORT.

F.) THIS OFFER IS SUBJECT TO BUYERS INSPECTION + APPROVAL OF INTERIOR OF HOME WITHIN 3 DAYS OF ACCEPTANCE OF OFFER.

G.) SELLER TO PROVIDE A 1 YR HOME PROTECTION PLAN AT A COST OF $285.—

BUYERS ARE LICENSED REALTORS

Set forth above any terms and conditions of a factual nature applicable to this sale, such as financing, prior sale of other property, the matter of structural pest control inspection, repairs and personal property to be included in the sale.

2. Deposit will ☐ will not ☒ be increased by $____________ to $____________ within ____________ days of acceptance of this offer.

3. Buyer does ☐ does not ☒ intend to occupy subject property as his residence.

4. The supplements initialed below are incorporated as part of this agreement.

____ Structural Pest Control Certification Agreement ____ Occupancy Agreement ____ Other ____________

____ Special Studies Zone Disclosure ____ VA Amendment ____ ____________

____ Flood Insurance Disclosure ____ FHA Amendment ____ ____________

5. Buyer and Seller acknowledge receipt of a copy of this page, which constitutes Page 1 of ____ Pages.

X [redacted] BUYER X ____________ SELLER

X [redacted] BUYER X ____________ SELLER

A REAL ESTATE BROKER IS THE PERSON QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE CONSULT YOUR ATTORNEY.

D-11-1 NCR SETS

Escrow Officer [redacted]

Subject Property [redacted] San Diego, California. [redacted]

[redacted] REALTY, INC.

[redacted]
Escrow Number
August 11, 1980
Date

*This escrow to close no later than August 29, 1980.

ESCROW INSTRUCTIONS

TO: [redacted] REALTY, INC. – ESCROW DIVISION

MEMO OF:	
CASH THROUGH ESCROW (from Buyer)	
(from New Loan)	60,000.00
Purchase Money TD	59,900.00
Encumbrances of Record	
**LESS Prpd. Finance	22,000.00
TOTAL CONSIDERATION	$97,900.00

I have handed the Broker $500.00 which he will deposit in escrow upon demand from you. I will cause you to be handed the balance of cash through escrow, which includes proceeds from new loan, if any, and Buyer's down payment, and I will hand you any additional funds and instruments required from me to enable you to comply with these escrow instructions, which you are to use on or before September 1,* 19 80 and when you can procure a Standard Owner's, Joint Protection and/or Loan Policy of Title Insurance with liability of $ 97,900.00

on real property in the County of San Diego State of California, viz: [redacted] in the City of San Diego, County of San Diego, State of California, according to the Map thereof No. [redacted], filed in the office of the County Recorder of San Diego County, [redacted].

(except any oil or mineral reservation now of record)

showing title vested in [redacted], Husband and Wife as Joint Tenants

free of encumbrances EXCEPT:

1. TAXES All for the fiscal year 19 80 to 1981 including levies for any district such as, but not limited thereto, drainage, irrigation, road improvement, acquisition and improvement, fire protection, etc. You make no report of personal property taxes.
2. BOND ASSESSMENTS NONE.
3. COVENANTS, CONDITIONS, RESTRICTIONS, RESERVATIONS, EASEMENTS, RIGHTS, AND RIGHTS OF WAY OF RECORD, INCLUDING SO-CALLED ZONING ORDINANCES, if any.

4) Trust Deed to record securing a note for $60,000.00 in favor of lender of buyers' designation. Escrow holder is hereby instructed to comply with the instructions of said new lender. Buyers' signatures on loan documents shall deem their full satisfaction and approval of the terms and conditions contained therein. **It is hereby understood that the amount of cash to be deposited herein by said new lender shall be $43,000.00 approximately. Escrow holder is instructed to charge buyers' account with the difference between $60,000.00 and amount being funded herein, as said difference represents prepaid finance costs to new lender. Any excess funds shall be disbursed to buyers.

5) Trust Deed to record securing a note for $59,900.00 in favor of [redacted], As Trustees under [redacted] dated April 24, 1980, bearing interest at eleven per cent per annum from close of escrow. Entire principal plus accrued interest shall be fully due and payable on or before three years from close of escrow date. It is understood that the total interest to be paid on said note shall be $19,767.00, making entire amount due, in three year time period, to be $79,667.00. Escrow holder is hereby authorized and instructed to insert dates, as herein set out, on note at close of escrow. Note to contain the prepayment penalty provision as set out on Exhibit "B" attached hereto and approved by all parties.

...Continued On Page Two..............

All parties signing this agreement hereby acknowledge receipt of a copy of these instructions.

PRORATE THE FOLLOWING:

Taxes based on latest available tax bills as of close of escrow Insurance handed you as of not applicable

Interest on new encumbrances by endorsements on notes to

Interest on loans of record as of not applicable Rents as of not applicable

based on rent statement handed you.

Credit seller and debit buyer the amount of impounds, if any, as disclosed by beneficiary statement from the holder of the loan of record. n/a

I/we will pay on demand for recording and/or drawing of documents necessary on my part and one-half escrow fee.

PARTIES HERETO ACKNOWLEDGE THAT THE BROKERS UNDER THE WITHIN TRANSACTION ARE AFFILIATED WITH THE WITHIN NAMED ESCROW COMPANY.

EACH PARTY SIGNING THESE INSTRUCTIONS HAS READ THE ADDITIONAL ESCROW CONDITIONS AND INSTRUCTIONS ON PAGE 2&3 HEREOF AND APPROVES, ACCEPTS AND AGREES TO BE BOUND THEREBY AS THOUGH PAGE 2&3 HEREOF APPEARED OVER THEIR SIGNATURES.

Buyer's Signature ______________________

[redacted] [redacted]

Address P. O. BOX [redacted] San Bernardino, CA 92413. Phone ______________

The foregoing terms, provisions, conditions and instructions, and those on the reverse side hereof are hereby approved and accepted in their entirety and concurred in by me. I will hand you necessary documents called for on my part to cause title to be shown as above, which you are authorized to deliver when you hold or have caused to be applied funds set forth above within the time as above provided. I/we will pay on demand charges for evidence of title as called for, recording and/or drawing of documents necessary on my part, required documentary tax on deed, demand or statement fees and one-half escrow fee. You are hereby authorized to pay bonds, assessments, taxes, and any liens of record to show title as called for.

Seller's Signature ______________________

[redacted] Trustee [redacted] Trustee

Address [redacted] CA 92120. Phone ______________

[redacted] REALTY, INC.
ESCROW DIVISION:

PAGE TWO

Escrow No. [redacted]

August 11, 19 80

Continued from Page One...............

Note and Trust Deed to contain the Acceleration Clause set out on Exhibit "A" attached hereto and approved by all parties. Trust Deed to contain the following recital: "This Deed of Trust is given as a portion of the purchase price of the herein described property, and is second and subsequent in lien to that first Deed of Trust being recorded concurrently herewith."
As further security for herein described note, it is understood that buyers shall execute in favor of sellers, an additional Deed of Trust on other property for an amount not less than $70,000.00. Escrow holder shall be handed further written instructions in regards to other property and recordation of said trust deed. Escrow holder is hereby authorized and instructed to draw and record a Request for Notice for the benefit of sellers on the first trust deed, and to charge sellers' account for drawing and recording fees for same.

TERMS AND CONDITIONS:

A) Escrow holder is hereby authorized and instructed to charge sellers' account and credit buyers' account, at close of escrow, with the sum of $13,000.00.

B) Sellers shall furnish a current structural pest control certification per attached addendum.

C) Buyers shall obtain a new fire insurance policy covering subject property, meeting new lender's requirements, and showing sellers as second mortgagee. Escrow holder is instructed to charge buyers' account for payment of first year premium for same, per billing deposited herein.

D) Buyers are aware that there are annual Seven Oaks Community Center dues of $65.00 on subject property. Escrow holder is instructed to obtain a statement from said center, charge sellers' account with any delinquencies, and pro-rate said dues to close of escrow.

E) Escrow holder is instructed that in lieu of the issuance of a CLTA Standard Coverage policy of title insurance, to have issued a CLTA Interim Binder, Form A, binding Commonwealth Land Title Company to the buyers for a period of not to exceed two years to the issuance of a policy in favor of a purchaser from the vestee herein. Buyers shall deposit sufficient funds herein to cover the ten per cent additional charge for said binder fee.

F) Buyers to receive copies of the Covenants, Conditions, and Restrictions affecting the rights to subject property.

EACH OF THE UNDERSIGNED STATES AND DECLARES THAT HE HAS READ THE FOREGOING INSTRUCTIONS AND UNDERSTANDS THEM AND DOES HEREBY ACKNOWLEDGE RECEIPT OF A COPY OF THESE INSTRUCTIONS.

SIGNATURE [redacted] SIGNATURE [redacted]

SIGNATURE [redacted] SIGNATURE [redacted]

C-21 JC FORM #9

AMENDED AND OR SUPPLEMENTED
ESCROW INSTRUCTIONS

[redacted] REALTY, INC.
ESCROW DIVISION:

Escrow No. [redacted]

August 28, 19 80

My instructions in the above numbered escrow are hereby supplemented in the following particulars only:

1) Cash through escrow from new First Trust Deed loan............$64,300.00**

2) Purchase Money Trust Deed and Note..........................$59,900.00

3) TOTAL CONSIDERATION..$97,900.00

Item No. 4, Page One of original escrow instructions is hereby amended to show a First Trust Deed in the amount of $64,300.00 rather than $60,000.00, and buyers are aware that policy of title insurance, to be issued at close of escrow, shall reflect a first trust deed in the amount of $64,300.00.

**It is understood that lender's charges shall be deducted from said $64,300.00 prior to their disbursement herein, and escrow holder is hereby instructed to charge buyers' account with said charges, per new lender's instructions. It is further understood that after the $13,000.00 credit to buyers and after the deduction of the $59,900.00 second trust deed, sellers shall receive $25,000.00 (less closing costs). Any excess funds monies disbursed by new lender escrow holder is instructed to disburse to buyers at close of escrow.

ALL OTHER TERMS AND CONDITIONS REMAIN THE SAME.

End of Amendment.

EACH OF THE UNDERSIGNED STATES AND DECLARES THAT HE HAS READ THE FOREGOING INSTRUCTIONS AND UNDERSTANDS THEM AND DOES HEREBY ACKNOWLEDGE RECEIPT OF A COPY OF THESE INSTRUCTIONS.

[redacted]
SIGNATURE [redacted]

[redacted]
SIGNATURE [redacted]

SIGNATURE

SIGNATURE

C-21 JC FORM 69

[redacted] REALTY, INC.
ESCROW DIVISION
[redacted]
San Diego, California 92120
[redacted]

STATEMENT OF ESCROW NO. ______ DOCUMENTS RECORDED August 29, 19 80

TO [redacted]
Dated April 24, 1980

PROPERTY [redacted]	PAYMENTS	RECEIPTS
CONSIDERATION OR SALES PRICE	$	$ 97,900.00
Paid XXXXXXXXX From Seller	13,000.00	
Deposits		
Deposits		
First Trust Deed		
Second Trust Deed	59,900.00	
PRO-RATIONS MADE AS OF 8-29-80		
Taxes for one-half year $ 186.69 Paid To 7-1-80	60.15	
$ Ins. Expiring ( ) Yr. Premium $		
Interest on $ @ % from to		
FHA Mtg. Prem. @ yr/mo from to		
HO Maintenance fee @ $ yr/mo from to		
Rent @ $ Per Mon. from to		
Seven Oaks Community Center $65 8-29 to 10-1-80		5.78
Security Deposit		
COMMISSION PAID TO [redacted] Realty, Inc.	5,094.00	
POLICY OF TITLE INSURANCE Commonwealth Land Title Insruance	403.50	
Calif. Documentary Stamps	107.80	
Recording: Request for notice	3.00	
Deed		
Trust Deed	8.00	
Reconveyance		
Bonds and/or assessments paid		
Taxes paid		
Trustees' Reconveyance Fees		
Sub Escrow Fee		
ESCROW FEE [redacted] Escrow	161.25	
Loan Tie in fee		
Drawing documents Grant deed, Request for notice	17.50	
Processing Beneficiary's demand and/or statement		
Termite: Callan Termite & Pest Control	30.00	
Fire insurance premium:		
Payment of Demand:		
Interest @ ____ from ____ to ____		
Forwarding Fee/Demand Fee		
Reconveyance Fee		
Less Impounds		
NEW LOAN CHARGES		
Loan Fee		
Discount Fee		
Interest @ ____ from ____ to ____		
Tax Impounds		
Insurance Impounds		
MMI Impounds		
Appraisal fee		
Photo and Inspection fee		
Credit report fee		
Documentation fee		
Balance due this Escrow		
Balance due you for which our check is enclosed	19,120.58	
TOTALS 113	$ 97,905.78	$ 97,905.78

STATEMENT OF ESCROW NO. ______ DOCUMENTS RECORDED August 29, 19 80

TO [redacted]

PROPERTY [redacted] San Diego 92128	PAYMENTS	RECEIPTS
CONSIDERA[redacted]	$ 97,900.00	$
Paid XXXXXXXXXX from seller		13,000.00
Deposits		
Deposits		
First Trust Deed		64,300.00
Second Trust Deed		59,900.00
PRO-RATIONS MADE AS OF 8-29-80		
Taxes for one-half year $ 186.69 Paid To 7-1-80		60.15
$ Ins. Expiring ( ) Yr. Premium $		
Interest on $ @ % from to		
FHA Mtg. Prem. @ yr/mo from to		
HO Maintenance fee @ $ yr/mo from to		
Rent @ $ Per Mon. from to		
Seven Oaks Community Center $65 8-29 to 10-1-80	5.78	
Security Deposit		
COMMISSION PAID TO		
POLICY OF TITLE INSURANCE Commonwealth Land Title Insruance	24.00	
Calif. Documentary Stamps		
Recording Power of Attorney	3.00	
Deed	3.00	
Trust Deed	4.00	
Reconveyance		
Bonds and/or assessments paid		
Taxes paid		
Trustees' Reconveyance Fees		
Binder	40.35	
Sub Escrow Fee	20.00	
ESCROW FEE [redacted] Escrow	161.25	
Loan Tie in fee	30.00	
Drawing documents 2 Trust Deeds and note	30.00	
Processing Beneficiary's demand and/or statement		
Termite:		
Fire insurance premium: Pro Insurance Services	152.00	
Payment of Demand:		
Interest @ ______ from ______ to ______		
Forwarding Fee/Demand Fee		
Reconveyance Fee		
Less Impounds		
To California First Bank per instruction	1,126.40	
NEW LOAN CHARGES		
Loan Fee lenders commission	7,073.00	
XXXXXXXXX disclosure fee	12.00	
Interest @ 19% from 8-29 to 9-14-80	576.98	
Tax Impounds		
Insurance Impounds		
MMI Impounds		
Appraisal fee	15.00	
Photo and inspection fee		
XXXXXXXXXXX Notary fee	2.00	
Documentation fee	50.00	
Loan escrow fee	230.00	
Balance due this Escrow		
Balance due you for which our check is enclosed Calif. First Bank	29,801.39	
TOTALS 114	$137,260.15	$ 137,260.15

"The Restructuring of the California Housing Finance System in the 1980s -- New Mortgages, New Lenders"

Testimony of
Professor Kenneth T. Rosen
Chairman, Center for Real Estate and Urban Economics
University of California at Berkeley
before Assembly Committee
on Finance, Insurance, and Commerce
August 5, 1981

The last two years have seen the beginning of a dramatic restructuring of the housing finance system in California and throughout the nation. This restructuring is a function of the interaction of market conditions and a strong deregulation effort on the part of the Federal Government. The market conditions have been characterized by extraordinarily high and volatile short and long-term interest rates. The volatility and the upward trend in interest rates has made it extremely difficult for the traditional mortgage lenders to create and hold long-term fixed rate mortgages profitably. At the same time, high mortgage rates have made homeownership prohibitively expensive for most first time entrants to the California housing market.

Coincident with, and partly caused by, these market conditions has been a move towards deregulation of the housing finance system. Interest rate ceilings on various deposit accounts at savings and loans, commercial banks, and credit unions have been tied to market interest rates in the initial deregulation phase. By 1986 at the latest, deposit ceilings on all deposit account types and maturities are scheduled to be removed.

In addition to this deregulation of liabilities, in the Spring of 1981, Federally chartered savings and loans and commercial banks have authority to make a wide range of variable rate and graduated payment mortgages. Essentially, for federally chartered institutions, the mortgage instrument has also been deregulated.

It is in this context of volatile and difficult market conditions, coupled with deregulation, that "creative financing" has become a significant factor in the mortgage market.

In the remainder of my testimony, I would like to outline the extent of "creative financing," the changing sources of mortgages, and a new mortgage instrument which may solve both the lenders' and borrowers' problem concerning high and volatile interest rates.

A. Extent of "Creative Financing"

The phenomenal growth of "creative financing" arrangements involves essentially two major mechanisms. The first is the "buydown" of mortgage interest rates for a 2-5 year period by a new home builder. Essentially, the builder is reducing his buyer's cost for a period of time by paying the interest for the buyer to the financial institution. Presumably, after this period of time, the borrower's income will have risen (because of inflation) so that he or she could afford market rate financing.

The second major mechanism concerns the financing of existing houses and often involves two elements: an assumption (transfer) of an existing low rate mortgage loan and a second mortgage loan by the seller at below market rates. The extent of this technique for financing existing home sales can be seen from the following chart. Column (1) shows the volume of new loan originations by institutional lenders for existing homes. Column (2) shows the product of existing home sales, house prices, and average loan to value ratios. Column (3) shows the ratio of Column (2) to Column (1), illustrating the amount of non-institutional mortgage lending and mortgage lending which involves the assumption of old mortgage loans. The ratio averaged .84 from 1970-1978, indicating that only 16% of mortgage lending was non-institutional or assumption lending. The ratio dropped to .72 in 1979, to .54 in 1980, and to .42 in the first quarter of 1981. This suggests that most financing of existing homes has not involved new mortgages from lending institutions.

Table I *

	Mortgage Originations Existing Homes (1)	Home Sales *Price* Loan to Value (2)	Ratio(2/1) (3)
1970 -1978	581 Billion	692 Billion	.84
1979	127 Billion	176 Billion	.72
1980	83 Billion	154 Billion	.54
1981:1	22 Billion	52 Billion	.42

* These are national figures. Presumably, because of the California Court's decision on "due on sale," the numbers would show an even greater disparity between new mortgage origination volume and Column (2).

B. Changing Sources of Mortgage Credit

"Creative financing" is only one symptom of the dramatic restructuring of the housing finance system underway. We have also seen a dramatic shift within the institutional lending community in terms of net mortgage extension (change in net holdings of mortgages). Table II shows the startling drop in the savings and loan and commercial bank mortgage share and the sharp rise in the role of the secondary market transactions (represented by mortgage pools) and in state and local government provision of mortgages through mortgage revenue bonds. Pension funds and life insurance companies have played a small but increasing role in the mortgage market. This trend towards an increase in secondary market transactions in which the ultimate holders of mortgages are different from the mortgage originators is likely to accelerate in the 1980s, especially in California. This will be primarily a result of the reduced role of savings and loans as specialized mortgage lenders.

Table II

Sources of Net Extensions of

Home Mortgage Credit

(Percentage)

	1978	1979	1980	
Households	8.1	7.5	6.7	
State & Local Governments	.1	3.1	9.3	
Sponsored Credit Agencies	8.5	8.5	9.4	
Mortgage Pools	15.0	22.2	26.0	Primary source of mortgage credit.
Commercials Banks	21.0	17.6	14.0	
Savings and Loans	43.2	35.7	30.4	
Life Insurance	0	1.6	2.1	
Pension Funds	.5	.5	1.0	
Other	3.6	3.3	1.1	

C. The Dual Interest Rate Mortgage: A Solution to the Borrower's and Lender's Problem

The fixed payment-fixed interest rate mortgage which has been the mainstay of the housing finance system for nearly 30 years has in the present environment of volatile and high interest rates and inflation rates created a serious "profitability crisis" for lenders and an "affordability crisis" for home buyers. In this type of economic environment, the fixed payment-fixed interest rate mortgage serves neither the borrower nor lender well.

On the lender's side, the main impetus for change has come from changes in federal regulations of deposit interest rates. These changes assure that the 1980s will be a decade in which the depository institutions will be forced to compete for liabilities in a deregulated environment. The introduction of the MMC and the two other variable rate certificates means that the financial institutions have to pay market rates for nearly all short and intermediate term liabilities. It is quite likely that variable rate certificates will be authorized for the full spectrum of maturities in the near future.

While deposit rate flexibility on all maturity classes would move a long way towards a competitive deposit market, a key issue concerns the ability of financial institutions to pay market returns on assets without causing massive failures of institutions. The only way financial institutions can afford to pay market rates on liabilities is if they are also allowed to receive market rates on all their assets. As a result, the movement toward market rates on liabilities has required regulators to introduce a fully variable rate mortgage instrument.

Thus, from the lender's perspective a fully variable rate mortgage is essential to lenders with a fully variable rate liability structure.

From the borrower's perspective, high inflation rates have also made the fixed payment-fixed interest mortgage outdated. The interest rate on the mortgage loan is crucially affected by the rate of inflation. The mortgage interest rate is a function of the expected inflation rate and a real interest component. The high inflation rates of the past several years have raised the contract interest rate and so raised the monthly carrying costs of a conventional mortgage by over 100%. Compared with a 1-2% inflation world, the present monthly carrying costs of a conventional mortgage are over five times higher than would be expected in a low inflation economy. This rise in mortgage payments, and the corresponding rise in the initial yearly payments/income ratio is of course the genesis of the "affordability crisis". In fact, it is <u>not</u> high nominal mortgage rates that have created the crisis but rather it is high mortgage rates juxtaposed with the archaic institutional mechanisms of the mortgage market that has created the problem. If the institutional arrangements of the mortgage market were flexible, then as long as the"real" mortgage rate had not risen dramatically, there would be no affordability problem. Unfortunately, however, the institutional arrangements in the mortgage market today were basically established for a low inflation world. The standard mortgage instrument is basically a level payment, amortized loan. This loan is not well adapted to an inflationary environment. It takes no account of inflationary induced rises in money income or inflationary induced increases in the underlying value of the property. Thus, from the borrower's viewpoint, the standard mortgage instrument completely ignores the positive inflation induced dynamics of the housing market. In an inflationary environment, it makes no sense to use a criteria for loan qualification based on an inflation bloated interest rate but a non-inflated income.

It is this situation which has created a dynamic mismatch between the cost of the mortgage loan to the borrower and the borrower's ability to pay. This dynamic mismatch is caused by the failure of the standard mortgage instrument, and the standard mortgage qualifying criteria to adapt to an inflationary environment. It is these archaic institutions which are a major element of the housing crisis.

Given the substantial institutional difficulties for both the borrower and lender of the existing mortgage instrument, we propose an alternative instrument which should alleviate many problems for most lenders and borrowers. The new instrument is known as a Dual Interest Rate Mortgage (DIM). This instrument sets two interest rates, one for the accrual rate by lenders on the mortgage debt, and one that determines the borrower's payment rate. The difference in the two rates would be added or subtracted from the principle balance of the loan. To handle the lender's problem concerning the volatility and trend of interest rates, the accrual rate could be variable with changes in the rate tied to changes in a short or medium term Treasury obligation. To handle the borrower's problem, the payment rate could be set on a graduated basis -- starting at say 10% and then rising 100 basis points per year. Depending on the time path of the accrual rate, the graduation period might last for five to ten years. In essence, the DIM mortgage is really a variation of the Graduated Payment Adjustable Rate Mortgage authorized last month by the Federal Home Loan Bank Board.

In summary, the DIM mortgage by solving both the lender's and borrower's problem would alleviate the need for much of the creative financing now occurring.

City Fed Sav. New Jersey
San Diego Federal

Advantages of this over blended rate:
80-90 LTV ratio won't be a problem if houses raise at close to rate of inflation

Exhibit No. 3

FINANCING SURVEY

Preliminary Findings

CALIFORNIA ASSOCIATION OF REALTORS®
Planning, Research and Economics Division
Joel Singer, Director
Kathy Schwarz, Analyst

I. Introduction

Traditionally, alternative financing has been utilized during periods of disintermediation (a phenomenon resulting from lenders' inability to attract adequate savings' inflows) or sustained high interest rates. Unable to obtain adequate institutional funding or confronted by unusually high borrowing costs, prospective home purchasers have generally sought and received alternative financing in previous housing downturns. Nevertheless, the penetration of non-institutional mortgage financing has historically been confined to not only a limited percentage of transactions, but to relatively short periods of time within the housing cycle. In this context, the current financing situation appears to represent a significant departure from past experience.

With interest rates more than 50 percent above previous records and given massive savings' outflows, the present real estate market downturn is disputably the most severe and protracted since World War II. While California institutional lenders have effectively withdrawn from the marketplace (with the exception of loans designed for secondary purchase), alternative financing opportunities have been aided by legal decisions and recent market patterns. The Wellenkamp decision in August 1978 prevented state-chartered lenders from exercising acceleration clauses contained in virtually all first mortgage loans. Legislative attempts to roll back this decision have been unsuccessful, while state courts have recently broadened their interpretation to allow assumption of loans originated by federally chartered associations. The passage of Proposition 2 in November 1979 (which removed the 10 percent usury ceiling) has also served to provide additional funds to the real estate sector. Concurrently, the record equity build-up accompanying the 20 plus percent appreciation rates of the past five years has provided many home-sellers with a substantial base for concessionary financing.

Against this background, many observers agree that "alternative" financing has been instrumental in maintaining even the present reduced transaction volumes. But if REALTORS® and recent homebuyers are generally supportive of non-traditional approaches, lenders (and increasingly regulatory authorities) have not been reticent to relate the potential dangers inherent in these financing arrangements. Confronted with significant losses and erosion of net worth, S&Ls have been in the forefront of these attacks. Despite the increasing institutional utilization of callable short-term loans, these critics have prophesied sharp dislocations as these limited term loans fall due.

Yet, regardless of one's position in the debate, there has been a paucity of hard information available as to the precise financing techniques engaged in today's housing market. This survey is directed toward partially filling this absence of meaningful data.

A. Survey Objectives

In addition to providing generalized information on present financing techniques, specific primary survey objectives include:

° Ascertaining the frequency of various alternative methods.

° Assessing the volume of short-term financing arrangements.

° Gauging the degree of seller involvement in real estate financing and the opportunities for maintaining liquidity.

° Differentiating the consumer impact of institutional vs. private financing arrangements.

° Evaluating the market dynamics and demographic utilization of traditional vs. alternative financing approaches.

° Relating different financing approaches to the marketability of properties.

B. Research Methodology

The selected survey approach consisted of a 2,100 member random sampling of 800 REALTOR® and 1,300 REALTOR-ASSOCIATE® members. Questionnaires (and prepaid return envelopes) were mailed in two separate waves with three weeks allowed for response. Over 330 valid questionnaires were received prior to specified deadline dates (an additional 30-plus questionnaires were received late and thus not utilized in the analysis). Responses were edited for consistency, coded and keypunched prior to computer processing.

The questionnaire requested detailed information as to the survey participant's most recent single unit residential resale transaction. Transactions occurring more than 12 months previously were eliminated from the analysis. In total, 113 bits of information were elicited (including a brief policy assessment section and participant demographics) in the course of the six page survey instrument. Most questions required closed-ended multiple choice or fill-in responses; several open-ended questions were also posed.

II. Survey Findings oc 4 Aug. 81

A. Sample Characteristics

From most indications, the 330 transactions comprising the survey sample appear to be representative of current market activity. Nearly eighty percent (78.4 percent) of the sample resales had closed escrow within the past 60 days with 57.1 percent having been finalized in the past month.

1. Dwelling Features - Sample transactions mirrored most indicators with 88.8 percent representing single family detached units and 11.2 percent condominiums. Three bedrooms were predominant with a 51 percent share. Two-or-less and four-or-more bedroom dwellings accounted for, respectively, 24.9 percent and 24.1 percent of sample transactions. Average reported square footage was 1,551 square feet, with the median slightly lower at 1,475 square feet.

2. Time on the market - The typical property sold after an interval of 2-3 months. The more detailed pattern is as follows:

Table 1 Time on Market

Less than 1 month	22.5 percent
1 month	16.9 percent
2 months	17.3 percent
3 months	13.0 percent
4-6 months	21.2 percent
7-12 months	8.1 percent

3. Original List Price - The average reported list price for homes in this sample was $130,100. The median (midpoint among all numbers within a series) list price was considerably lower at $105,000.

4. Final Sales Price - As anticipated, final sales prices were generally 3-6 percent below the asking figure. For the entire sample, the average price at closing was $123,200, with a median of $102,000. These figures correspond closely to other statistical series of resale transaction prices. A more detailed breakdown is presented in the following Table.

Table 2 — Final Sales Price

less than $ 49,999	4.6%
$ 50,000 - $ 74,999	14.4%
$ 75,000 - $ 89,999	17.2%
$ 90,000 - $104,999	16.3%
$105,000 - $124,999	13.8%
$125,000 - $149,999	12.5%
$150,000 - $199,999	12.0%
$200,000 +	9.2%
	100.0%

5. Downpayments - Downpayments ranged from 0 (in two cases) to a maximum of $300,000. For the sample as a whole, the average downpayment was $36,000 (median downpayment equalled $24,000). The great majority (82.4 percent) of downpayments were in the $50,000 or under category. On the average, the typical downpayment was 24.1 percent of sales price. As a percentage of final sales prices, downpayments varied from 20.7 percent to 43 percent.

B. Financing Characteristics: General

Perhaps the clearest conclusion to be drawn from the preliminary data concerns the extent to which the current market is dependent on alternative approaches. The traditional 80 percent institutional first now accounts for a rather small proportion of activity, with assumptions and owner participation being far more significant. Generalized approaches to financing are summarized in Table 3.

Table 3 — Types of Financing Utilized

Type of Financing	Relative Frequency	Adjusted Frequency
Cash and new first mortgage loan	23.1%	25.3%
Cash and new first mortgage loan plus 2nd and/or 3rd	5.2%	5.6%
Cash and assumption of existing first mortgage loan	14.6%	15.9%
Cash and assumption of existing first mortgage loan plus a 2nd	27.1%	29.7%
Cash and assumption of existing first mortgage loan plus a 2nd and 3rd	14.6%	15.9%
Wrap-around (AITD)	7.0%	7.6%
All Cash	1.2%	---
Other: Installment sale/land contract	1.5%	---
FNMA resale program	1.5%	---
All others	4.2%	---
	100.0%	100.0%

The survey provides clear evidence as to the importance of assumptions in the current marketplace. Eliminating the portion of sales in the "all cash" and "other" categories, we find that 61.4 percent of transactions have been based on straight assumptions. In conjunction with AITDs, this figure increases to nearly 7 out of 10 transactions being premised on financing arrangements which preserve outstanding lower interest rate loans.

C. Monthly Payments: General

Total monthly dollar housing expenditure and the proportions devoted to each element within the financing package was extremely varied. Although composite purchase statistics obscure the differences among different transaction modes, this data is more suggestive of actual market conditions than the more traditional measures offered by government agencies (including the FHLBB, the Bureau of Labor Statistics and others). Eliminating the "all cash" and "other" categories provides the following composite payment pattern. Based on an average sales price of $121,290 and a typical $33,788 (28.3 percent) downpayment, total monthly payments averaged $940. Based on this hypothetical composite, these payments can be broken down as follows:

Table 4 Composite Housing Expenditures

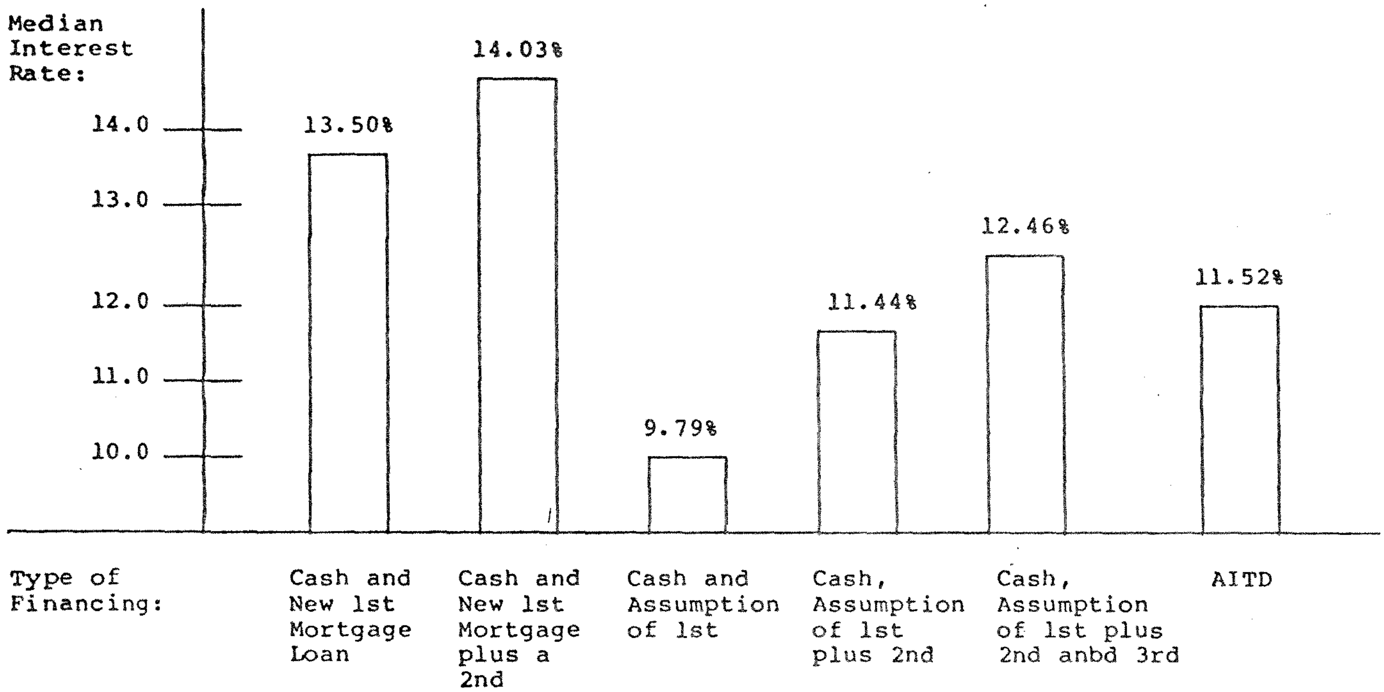
Final sales price (average)		$121,390
Downpayment (average)		$ 33,788
Monthly Payment 1st (or AITD)		$ 632
2nd		$ 256
3rd		$ 52
	TOTAL	$ 940

This mean monthly payment of $940 on an average outstanding balance of $87,602 translates into the equivalent of 12.57 percent interest rate on a conventional 30-year loan. With institutional rates having averaged over 15 percent during the past 18 months, the attraction of alternative financing to homebuyers is quite apparent. Note, however, that balloon payments and shorter-term due dates make this type of analysis somewhat illusory.

D. Interest Rates

If the composite monthly payment analysis above suggests a typical monthly payment comparable to a 12 1/2 percent 30 year loan; in actuality, differing financing arrangements produced substantial variation in interest rates. Most secondary financing involved terms of far shorter than 30 year duration, thus interest charges often varied substantially at different points with even a fully amortizing financing package. Eliminating the "all cash" and "other" categories, the median interest rate was 12.02 percent.

Table 5: Median Interest Rate by Financing Type



Predictably, the lowest median interest rates were found in the instance of a cash downpayment to an assumable existing loan; while a new first mortgage and a second produced the highest rates.

E. Traditional vs. Alternative Financing Approaches

1. Newly originated mortgages - Slightly more than 3 out of 10 transactions (30.9 percent) in our sample utilized a newly originated first mortgage loan. Less than one-fifth (18.3 percent) of these were accompanied by the use of junior trust deeds. Although firsts were written up to $400,000, 79.3 percent fell below the $98,500 purchase limit of the institutional secondary market. The typical loan-to-value ratio for newly originated mortgages was 76 percent.

Not surprisingly, newly originated mortgages were based on relatively high interest rates averaging 13.78 percent (median=13.99 percent). Interestingly, 40.8 of new mortages were originated at rates below 13 percent, while 32.9 percent bore 15 percent or higher rates. Typical loan terms also reflected the impact of high inflation and economic uncertainty. The traditional 30 year period was featured in only 61.4 percent of newly originated loans, nearly one-fifth had terms of five years or less. Although detailed information is not yet available, seller carrybacks exhibited a tendency to be short-term arrangements.

The market share of institutional lenders reflected current pressures on lending capability. Owners and mortgage companies accounted for nearly 60 percent of the new firsts originated (with nearly one-quarter of all new mortgages being FHA or VA financing). A more detailed breakdown is presented in Table 5.

Table 6 Source of Newly Originated First Mortgage Loan

State Chartered S&L	20.7%
Federally Chartered S&L	12.6%
Bank	4.6%
Mortgage Company	24.1%
Owner	35.6%
Other	2.3%
	100.0%

Interest rates and other terms varied between the originators of these new loans. Interest rates were significantly higher for institutional firsts (with a 14.77 percent median), than for owner carrybacks (median=12.13 percent). However, institutional mortgages were generally written for significantly longer terms than were owner first loans, whereas the median newly originated institutional first carried a 29.9 year term, sellers offered firsts with a median term of 5.4 years.

The importance of seller financing and the secondary market was also underscored by the frequency of conventional fixed rate loans. These accounted for 60.9 percent of the newly originated firsts while 21.7 percent involved non-specified hybrid mortgages or new loan programs. Collectively, GPM's, VRM's, RRM's and ARM's were involved in 17.2 percent of those transactions featuring new firsts.

2. Assumptions - In myriad forms, assumptions are clearly the most significant financing vehicle in today's marketplace. Assumptions with and without junior trust deeds accounted for 61.5 percent of the transactions in this survey.

   a. "Subject to" vs. "formal assumption" - Reflecting legal realities and the historical dominance of state-chartered lenders, mortgages taken "subject to" accounted for 64.7 percent of the total loans assumed. Although more costly and often involving an upward interest rate adjustment, formal assumptions were utilized with some frequency (35.3 percent of all assumptions). Although detailed analysis is again incomplete, the majority of formal assumptions appear to have occurred at federal institutions.

   b. Loan amounts/remaining term - More than three quarters (77.3 percent) of all assumptions used mortgages originated between 1977 and 1980. Resultingly, most assumed loans entailed relatively long remaining amortization periods - with the average being 25.3 years (median=27.0 years).

Amounts assumed ranged from $8,100 with an average figure of $58,815 (median=$56,140). A more detailed breakdown is presented in Table 6.

Table 7 Remaining Balance on Assumptions

$ 24,999 or less	13.3 percent
$ 25,000 - 49,999	25.6 percent
$ 50,000 - 64,999	23.9 percent
$ 65,000 - 79,999	19.4 percent
$ 80,000 - 99,999	8.9 percent
$100,000 or more	8.9 percent
	100.0 percent

For assumptions as a whole, the average first mortgage loan-to-value ratio was 47.3 percent. This relatively low figure required fairly substantial downpayments (averaging 30.4 percent of final sales price) and extensive use of secondary financing (see below).

c. Interest Rates - Given adequate fund availability, the principle advantage to assumption lies in the preservation of significantly lower interest rates. The average rate on existing formally assumed firsts was 9.97 percent. Even with interest rate adjustments accompanying formal assumptions, all first mortgages assumed carried an average rate of 10.4 percent (median=10.0 percent). Although the advantage of these below market rates was often reduced by higher cost secondary financing, overall payments were generally held well below the levels of newly originated loans.

d. Assumption Procedures - Although analysis in this area has not been completed, it appears that "subject to" assumptions were accompanied by only nominal charges and procedures. The most common charge was for a beneficiary statement with lender record changes also being frequently required.

e. Secondary Financing - With the soaring appreciation of the last several years, the relatively low loan-to-value ratios attached to assumption possibilities frequently necessitated secondary financing. Only 25.9 percent of all assumption based transactions were completed without junior trust deeds. In nearly one-half of the cases (48.1 percent), an assumed first was accompanied by a second, while 25.9 percent required both second and third trust deeds. Although seconds (accompanying assumptions) ranged in amounts from $1,600 to $161,000, over 50 percent fell below $24,300. Thirds were generally of lower dollar value and ranged from $3,500 to $73,000 (median=$14,000).For both types of junior deeds, interest rates varied from 8.5 percent to 21 percent (with averages in the 13-14 percent range). The great majority of junior loans involved owner participation. (More detailed analysis on secondary financing and its implications follow in a separate section.)

3. AITD's - Though less significant than other types of alternative financing, all-inclusive trust deeds, or wrap-around mortgages, accounted for 7.6 percent of the total transactions in this survey. Most frequently -- 91.3 percent of the time -- the seller of the property carried-back the new loan, the remainder being originated by a third-party. The underlying first mortgage loan was held most often by state-chartered savings and loan associations, 59 percent, with commercial banks and mortgage companies accounting for 22.7 percent and 18.2 percent of the existing firsts, respectively.

The typical loan-to-value ratio for wrap-around was 77.3 percent. Although wrap-around mortgages were written for up to $180,000, 78.3 percent fell below $100,000, with the average amount of the wrap-around loan being $79,402.

The average remaining balance of the underlying first mortgage was $33,447. Thus, the typical buyer was able to borrow an additional average amount against the property of $45,955. A more detailed breakdown is presented in Table 8.

Table 8 Composite AITD Terms

Average amount of AITD	$ 79,402
Average remaining balance of underlying first	$ 33,447
Average additional amount financed	$ 45,955
Average interest rate on AITD	11.80%
Average interest rate on existing first	8.78%
Average spread	3.02%

The remaining term of the underlying first averaged 19.7 years. Because AITD's are typically intended as an interim financing arrangement, the average term of the wrap was only 7.1 years, though 78 percent of AITD's were written for terms of 5 years or less. The underlying firsts carried an average interest rate of 8.78 percent (though rates ranged anywhere from 5.25 percent to 11.0 percent) and the wrap-around mortgages carried rates averaging 11.8 percent; thus, on the average, sellers earned a spread of 3.0 percent interest on their existing mortgage, increasing their yield to roughly 14 percent on the additional amount of the wrap.

E. Secondary Financing

Slightly more than half of total transactions in which a first mortgage loan was either newly originated or assumed involved secondary financing. In 69 percent of these transactions, junior financing was limited to a second trust deed, with the remainder involving the origination of both a second and third trust deed.

Second Trust Deeds

1. General: Fifty-seven percent of all transactions involved the origination or assumption of a second trust deed. The majority of these, 67.7 percent, were owner carrybacks; 22.6 percent were originated through an institutional lender, including savings and loan

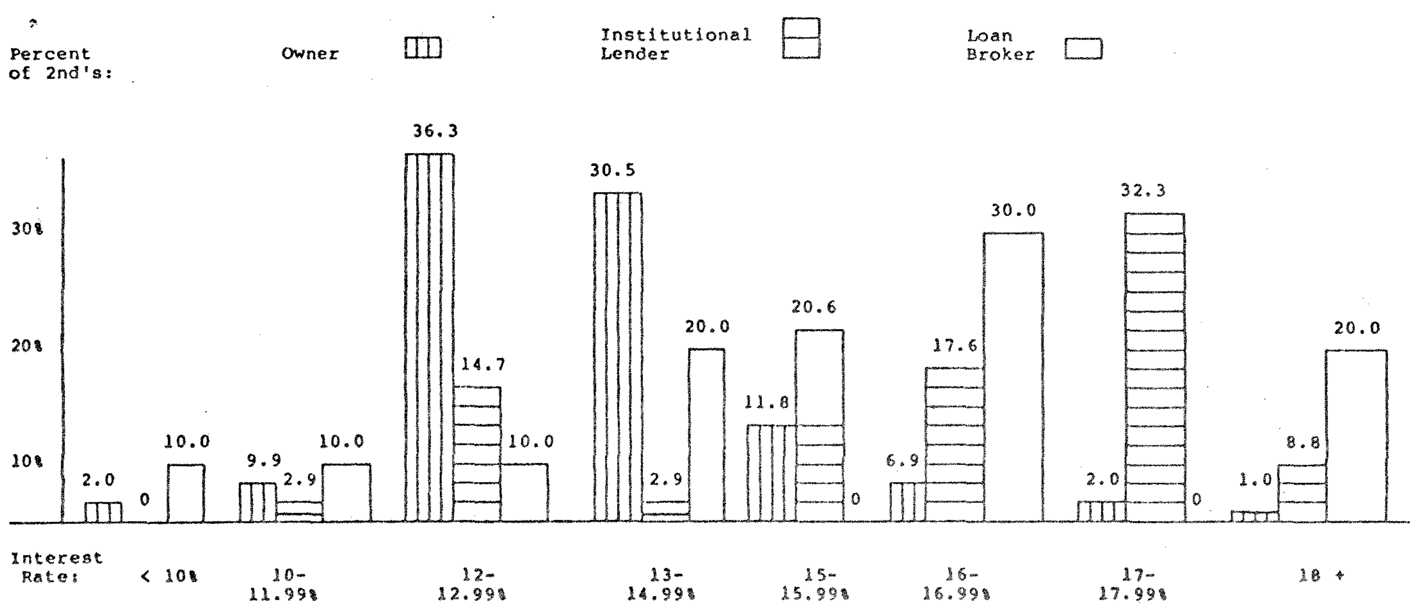
associations, commercial banks and credit unions. Only 6.5 percent of second TD's were financed through loan brokers or third party investors. Twelve percent of the owner-carry-backs were discounted and sold to a third party investor. Although seconds were originated in amounts up to $261,000, 75 percent were for $40,000 or less, with the average-sized second being $31,397. The average interest rate on second trust deeds was 13.81 percent.

Only 10.5 percent of second trust deed monthly payments were structured to cover less-than-interest-only. Slightly more than 46 percent had monthly payments covering principal and interest. The remainder, 43.1 percent, had monthly payments which covered only interest. Because more than half of second trust deeds involved interest-only or less-than-interest-only monthly payments, and because the average term of seconds (6.3 years) was not sufficient to allow for full amortization, 79.6 percent of seconds involved a balloon payment at maturity. Nearly half of all seconds, 47.7 percent, were assumable by subsequent buyers.

2. Second Trust Deed Characteristics varied by the source of financing. Owner carried-back seconds tended to be smaller than those originated through institutional lenders, $22,289 compared to $30,050. Seconds originated through loan brokers or third party investors averaged $18,100.

Interest rates on second trust deeds also varied by source of financing. (See Table 9: Second Trust Deeds: Interest Rate by Source of Financing.) Owner-carries averaged a 12.9 percent interest rate; interest rates on owner carry-backs ranged between 8.0 percent and 18.0 percent. By contrast, institutional seconds had an average interest rate of 16.13 percent with rates ranging between 10.75 percent and 18.0 percent. Second trust deeds originated through loan brokers carried an average interest rate of 14.1 percent, and ranged between 8.5 and 18.0 percent.

Table 9 Second Trust Deeds: Interest Rate By Source of Financing



The structure of monthly payments on seconds differed significantly by source of financing. Monthly payments on owner carry-back second trust deeds were generally interest only, accounting for 48 percent; 36.3 percent of monthly payments were structured to include repayment of principal. Only 15.7 percent of owner-carry seconds permitted less-than-interest only payments which involve additions to the outstanding principal balance. By comparison, 84.8 percent of institutional seconds were structured so that monthly payments were applied to both interest and principal; only 15.2 percent of monthly payments were interest-only and none of the institutional seconds allowed a less-than-interest-only payment structure. Similarly, none of the seconds originated through loan brokers or third-parties involved less-than-interest-only monthly payments, though 77.8 percent of payments were structured as interest-only.

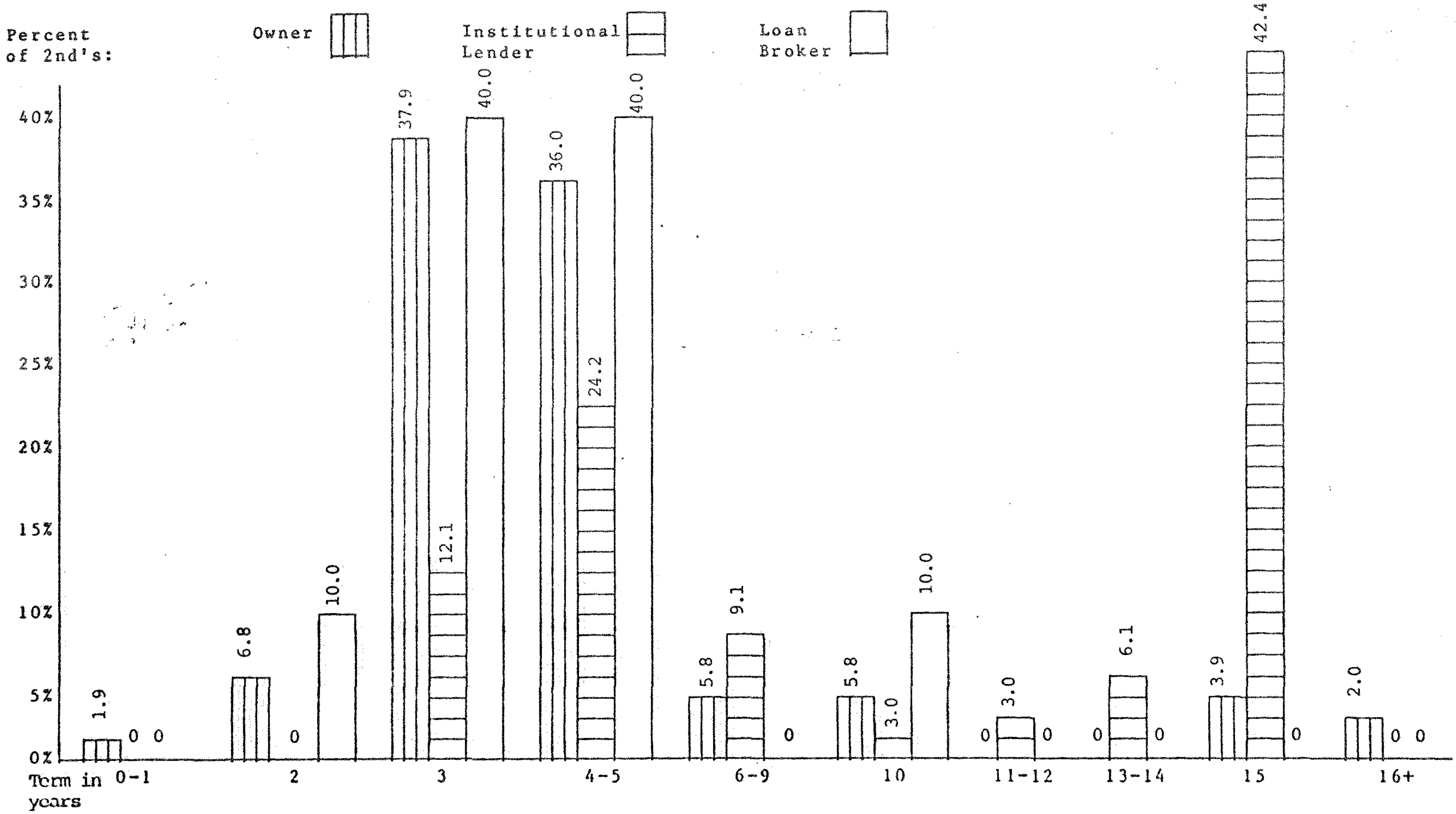
Length of term to maturity of second trust deeds also varied by source of financing. (See Table 10: Second Trust Deeds: Term to Maturity by Source of Financing.) Maturities on owner carry-backs ranged between one year and 35 years, though 37.9 percent were written form terms of 3 years, and 28.2 percent were written for 5 years. The average owner carry-back term to maturity was 3.9 years. Institutional second trust deeds generally carried longer terms to maturity, averaging 12.0 years. Forty-two percent were written for a term of 15 years; (these were generally fully-amortized over the period). Twenty-one percent were written for a 5 year term and 12.1 percent were written for a term of 3 years, the latter being the shortest term among institutional seconds. Terms on seconds originated by a 3rd party or loan broker ranged between 2 years and 10 years, averaging 3.5 years in length.

Balloon payments at maturity were present in 92.1 percent of owner-carried seconds, 44 percent of institutional seconds and 100 percent of seconds originated through a 3rd party or loan broker. The amount of the balloon payment varied depending upon term to maturity and type of monthly payment.

The assumability of second trust deeds was briefly examined in the survey. Not surprisingly, most sellers (67.7 percent) carrying back a second preferred that the second not be assumed. Given the concessionary nature of most owner carry-backs, these restrictions on subsequent assumptions were hardly unanticipated. In addition, this also presumably reflects sellers' desire to recover equity at the earliest feasible moment.

A third trust deed was originated in 21 percent of the transactions involving an owner carry-back of a second; the vast majority of these, 81.8 percent, were also carried by the owner. Third trust deeds were originated in 51.4 percent of the sales where the second was financed through an institutional lender; again, the most common source for the thirds was the selling owner. Sixty percent of loan brokers/third party seconds had a third trust deed originated with owners similarly providing the financing most often. That owners found it necessary to carry back a third trust deed (and in most cases, the second as well) in order to affect the sale of their home, underscores the inability of the current market to provide mortgage financing at

Table 10: Second Trust Deeds: Term to Maturity by Source of Financing



terms and interest rates appropriate to underlying demand. Table 11 presents a detailed breakdown of second trust deed loan characteristics by source of financing.

Table 11 Characteristics of Second Trust Deed Loans

	Owner Carry-Back	Institutional Lender	Loan Broker or 3rd Party Investor
Amount (median)	$22,289	$30,050	$18,100
Interest rate (median)	12.9%	16.13%	14.1%
Type of monthly payment:			
Interest-only	48.0%	15.2%	77.8%
Principal and Interest	36.3	84.8	22.2%
Less-than-interest-only	15.7	0	0
Median Term	3.9 years	12.0 years	3.5 yrs.
Balloon payment	92.1%	44.0%	100.0%
Third Trust Deed?	21.0%	51.4%	60.0%
Source of Third Trust Deed:			
Owner carry-back	81.8%	94.4%	83.3%
Institutional lender	0	0	0
Loan Broker/3rd Party	13.6%	5.6%	16.7%
Other	4.5%	0	0
Number of Second Trust Deeds	105	35	10

Third Trust Deeds

Third trust deeds were originated or assumed in only 19.7 percent of all transactions. The majority of thirds, 87.8 percent, were owner carry-backs; 10.2 percent were originated through loan brokers or third party investors. None of the third trust deeds were originated by institutional lenders.

Thirds ranged in size up to $73,000, but the majority were less than $14,500. The average sized third trust deed was $14,400, and carried an average interest rate of 13.96 percent. Interest rates on thirds ranged between 10.0 and 21.0 percent. Monthly payments on third trust deeds were most often structured as either interest-only (44.7 percent) or as less-than-interest-only (40.4 percent). Only 14.9 percent of third trust deed monthly payments were structured to include principal and interest.

The term to maturity of third trust deeds averaged 3.0 years, though ranged as high as 10 years. The vast majority of thirds, 95.7 percent, involved a balloon payment at maturity.

F. Consumer-Impacts - Buyer and Seller Demographics

Though further analysis of the data is required, general information on the characteristics of all buyers and sellers is available, and presented below in Table 12.

Table 12 — Buyer and Seller Demographics

Percentage of properties to be occupied by buyer as primary residence	77.6%
Percent first-time buyers	28.8%
Median age of buyers	35.4 yrs.
Median age of sellers	43.1
Median income of sellers	$ 33,595
Percent of sellers occupying property when originally listed or sold	63.8%

Perhaps the most unexpected finding, the percentage of buyers purchasing a home for the first time accounted for fully 28.8 percent of all buyers. This is in sharp contrast to earlier studies which placed the percentage of first-time buyers at less than 18 percent nationwide, and at less than 17 and 14 percent in the Los Angeles and San Francisco areas respectively.

Table 13 presents the differences between first-time and repeat buyers, although financing strategies and demograhic characteristics were similar among both groups, first-time buyers typically purchased lower priced (and smaller) homes with less down. First-time buyers were generally younger, and had lower incomes on the average than did repeat buyers.

Table 13 — First-Time Buyers vs. Repeat Buyers

	First-Time Homebuyers	Repeat Buyers
Final sales price (median	$89,025	$110,000
Downpayment (median)	$16,200	$ 26,100
percent financed	81.8%	76.3%
Median age	30 years	37.9 years
Median income	$31,904	$41,025

G. Marketability

The analysis of the impact of the various financing approaches on the marketability of properties is incomplete at this time. Initial findings, however, suggest that properties on which an assumption of an existing first was involved in the transaction, Thus, it appears that to some extent, market flexibility is enhanced by the availability of alternative financing in a tight money market. Further analyses examining these and other issues of marketability are forthcoming.

III. Preliminary Conclusions

Though more in-depth analyses of the information collected are forthcoming, some very preliminary conclusions can be made at this time.

First, it appears that the current market is dependent, to a great extent, on the availability of alternative financing approaches. With the effective withdrawal from the market of institutional lenders, and the exorbitant interest rates involved when new first mortgages are originated, alternative financing has been critical in maintaining even the presently reduced transaction volume.

Second, the most common type of alternative financing involves the assumption of an existing first mortgage loan and the origination of a second trust deed. Generally, it is the seller who originates the second, though institutional lenders account for 23 percent of these loans.

Third, to some extent, alternative financing approaches appear to enhance the flexibility of the transaction, and thus, the marketability of the properties with which these approaches are used.

Finally, first-time homebuyers appear to comprise a more significant share of the market than has been generally believed. The extent to which various factors can explain this finding is under study.